S. HRG. 109–785

POTENTIAL EFFECTS OF A FLAT FEDERAL INCOME TAX IN THE DISTRICT OF COLUMBIA

HEARINGS

BEFORE A

SUBCOMMITTEE OF THE

COMMITTEE ON APPROPRIATIONS

UNITED STATES SENATE

ONE HUNDRED NINTH CONGRESS

SECOND SESSION

SPECIAL HEARINGS

MARCH 8, 2006—WASHINGTON, DC
MARCH 30, 2006—WASHINGTON, DC

Printed for the use of the Committee on Appropriations

Available via the World Wide Web: http://www.gpoaccess.gov/congress/index.html

U.S. GOVERNMENT PRINTING OFFICE

27–532 PDF WASHINGTON : 2007

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2250 Mail: Stop SSOP, Washington, DC 20402–0001

COMMITTEE ON APPROPRIATIONS

THAD COCHRAN, Mississippi, *Chairman*

TED STEVENS, Alaska	ROBERT C. BYRD, West Virginia
ARLEN SPECTER, Pennsylvania	DANIEL K. INOUYE, Hawaii
PETE V. DOMENICI, New Mexico	PATRICK J. LEAHY, Vermont
CHRISTOPHER S. BOND, Missouri	TOM HARKIN, Iowa
MITCH McCONNELL, Kentucky	BARBARA A. MIKULSKI, Maryland
CONRAD BURNS, Montana	HARRY REID, Nevada
RICHARD C. SHELBY, Alabama	HERB KOHL, Wisconsin
JUDD GREGG, New Hampshire	PATTY MURRAY, Washington
ROBERT F. BENNETT, Utah	BYRON L. DORGAN, North Dakota
LARRY CRAIG, Idaho	DIANNE FEINSTEIN, California
KAY BAILEY HUTCHISON, Texas	RICHARD J. DURBIN, Illinois
MIKE DeWINE, Ohio	TIM JOHNSON, South Dakota
SAM BROWNBACK, Kansas	MARY L. LANDRIEU, Louisiana
WAYNE ALLARD, Colorado	

J. KEITH KENNEDY, *Staff Director*
TERRENCE E. SAUVAIN, *Minority Staff Director*

SUBCOMMITTEE ON THE DISTRICT OF COLUMBIA

SAM BROWNBACK, Kansas, *Chairman*

MIKE DeWINE, Ohio	MARY L. LANDRIEU, Louisiana
WAYNE ALLARD, Colorado	RICHARD J. DURBIN, Illinois
THAD COCHRAN, Mississippi *(ex officio)*	ROBERT C. BYRD, West Virginia *(ex officio)*

Professional Staff
MARY DIETRICH
KATE ELTRICH *(Minority)*

Administrative Support
LASHAWNDA SMITH

CONTENTS

WEDNESDAY, MARCH 8, 2006

THURSDAY, MARCH 30, 2006

POTENTIAL EFFECTS OF A FLAT FEDERAL INCOME TAX IN THE DISTRICT OF COLUMBIA

WEDNESDAY, MARCH 8, 2006

U.S. SENATE,
SUBCOMMITTEE ON THE DISTRICT OF COLUMBIA,
COMMITTEE ON APPROPRIATIONS,
Washington, DC.

The subcommittee met at 2:05 p.m., in room SD–124, Dirksen Senate Office Building, Hon. Sam Brownback (chairman) presiding.

Present: Senators Brownback and Allard.

OPENING STATEMENT OF SENATOR SAM BROWNBACK

Senator BROWNBACK. Good afternoon. I'm delighted to have you all here to discuss a very interesting topic, a very important topic that we're going to explore this afternoon.

We're going to look at creating a fairer, simpler tax system in the District of Columbia. I believe that a voluntary flat Federal income tax for the District of Columbia residents would give us real-world valuable information about whether a flat tax is actually better than the current cumbersome system. I believe most taxpayers in the District of Columbia would welcome this opportunity. I believe most taxpayers in my State of Kansas would welcome this opportunity. But since I do not believe that we should merely impose a new system on D.C. taxpayers overnight, I would suggest that those who want to stay under the current tax system should feel free to do so. I think, however, that if people are given a chance, they'll abandon the current burdensome system.

What we are discussing here is creating an optional flat tax in the District of Columbia. Every year, taxpayers in the District of Columbia suffer, like all Americans, from the burden of our complex and complicated Tax Code, confused by over 800 pages of IRS tax forms, perplexed by hundreds of pages of IRS instruction books, and nervous that they will make a mistake trying to calculate how much of their own money they have to hand over to the Federal Government.

Now, I want to show you something here. We've got the Internal Revenue Code here. And here is just the Internal Revenue Code. I'm just holding it up for thickness. I did my weightlifting this morning so I could get this done. This is just the Internal Revenue Code itself. These are the words. I want to show you, if you're thinking this is the big-print edition of it, it's not; it's very fine print on all those pages.

Now, that's not enough. I'm trained as a lawyer, I have to admit. You don't just go to the Code, you go to the regs to understand the

Code. This is the Internal Revenue Code regulations that interpret these books. So, this is setting the guidance for what these laws are. And I want to just stack these all in front of you, so you can see the size of the Internal Revenue Code. And the laws and the books that interpret them is this size. This stack is the Internal Revenue Code and the regulations. It is unbelievably complex. It is unintelligible. You can have the most intelligent tax lawyer in the world, five of them, and they'll give you five answers to the same question. It is too burdensome. It is too complicated. As one tax expert told me, it needs to be taken out behind the barn and killed with a dull axe. It's too much. And I can barely lift it, on top of that.

We need to create a different system. We need a system that people can understand, that's comprehensible.

This confusion of the current Tax Code is one reason why almost two-thirds of all taxpayers have given up trying to figure out how to complete their own tax returns. Two-thirds now spend more of their hard-earned money just so someone else can try to sort it out. And I don't blame them. I do the same thing.

I believe that our tax system should be fair, simple, and easy to understand. One way to make the system fair is to have taxpayers pay taxes based on a single flat rate that is applied to all taxpayers equally. Such a flat tax rate would only be applied to the amount of earned income above an exemption level, based on family size. Such an exemption level should be somewhere between $5,000 and $7,000 for each member of the household, so, at the higher exemption level, a couple with two children earning $28,000 would pay no Federal income tax at all.

I do not think that the dollars that wage-earners have already paid taxes on should be taxed again when those dollars are saved or invested. This is a double taxation. It's a disincentive to savings and a disincentive to investing.

As long as a flat tax rate is reasonable, it is a fairer tax than the current system, because it taxes all earned income at the same rate. Workers would not be punished for working harder and earning more money, because each dollar that they earned would be taxed at the exact same rate. This is fairer, it is simpler, and is a much easier to understand system, which would produce more economic activity and jobs.

For years and years, policymakers and economists have debated how taxpayers would fare under a flat tax. I think we should stop speculating and debating and actually test the idea of a flat Federal income tax, and do it here in the District of Columbia, the Federal district. Some have questioned why we should give the District of Columbia this opportunity for fairer and simpler tax treatment while the rest of the Nation must continue to labor under the present nightmarish Tax Code. Believe me, I'd like to see a fairer tax system for all taxpayers in every American city, particularly for taxpayers in Kansas. And I would offer that we could do this as a model for the District of Columbia and Kansas, if you want to try two places. That would be fantastic.

Now, while everyone talks about the need to simplify the Tax Code, real reform has been stymied by those who come up with all kinds of excuses to prevent us from fixing the broken system. The

Federal Government has the authority to try a first-ever flat Federal income tax here in the Nation's Capital, because of the unique relationship it has with the District of Columbia, which our founding fathers set out in article I, section 8 of the Constitution. One result of Washington, DC being the seat of the Federal Government is that 42 percent of all District property is not subject to local taxation. By Federal law, the District is precluded from taxing income at its source for those workers who are not residents of the District. The result is that 70 percent of income earned in the District cannot be taxed to support District municipal services. To some extent these Federal restrictions on the District's taxing authority have led city leaders to impose very high local income, property, and sales tax. In fact, for decades, residents of Washington, DC have endured one of the Nation's highest tax burdens. These high tax rates have been one reason that between 1970 and 2003, the District's population dropped by 26 percent, even though every neighboring county gained in population during this same time period.

I believe that a flat Federal income tax would create more economic activity and jobs in the District, which would enhance the District's ability to raise revenues while actually lowering its own high local taxes.

I look forward to hearing from our panel of distinguished experts about how a flat Federal income tax could work in the District of Columbia and what they think the effects of such a system would be.

I'll introduce our panelists now, all together, and then we will have each of them present their testimony. And I'm looking forward to this.

First would be the Honorable Dick Armey. He spent 18 years in the House of Representatives serving as majority leader from 1994 until 2002. Since he's retired from the House, Mr. Armey has continued his fight for lower taxes, less government, more freedom as co-chairman of the grassroots nonprofit organization FreedomWorks.

Daniel J. Mitchell is the McKenna senior fellow in political economics at The Heritage Foundation. His major research interests include tax reform, Social Security, and international tax competition. He's one the Nation's leading experts on the flat tax.

Stephen J. Entin is president and executive director of the Institute for Research on the Economics of Taxation. He was Deputy Assistant Secretary for Economic Policy at the Treasury Department from 1981 to 1988, and developed the 1981 tax cuts in President Reagan's enterprise zone legislation.

And our final witness is Chris Edwards, who's director of tax policy studies at the Cato Institute. He's an expert on Federal, State, and local tax and budget issues. Previously, he was a senior economist on the congressional Joint Economic Committee examining tax, Social Security, and entrepreneurial issues.

I want to thank each of you for being here today. We will include your full statements into the record. I would ask, if you could, to make your presentations around the 7-minute mark, if you can, so that we can have a good discussion afterward. I do appreciate each of you coming to discuss this issue of a flat tax in the District of Columbia.

Honorable Dick Armey, delighted to have you back in these halls, and the microphone and the floor is yours.

STATEMENT OF HON. RICHARD K. ARMEY, CHAIRMAN, FREEDOMWORKS

Mr. ARMEY. Thank you, Mr. Chairman. And let me say, it's a pleasure for me to be back, as well, and especially addressing this subject, which is near and dear to my heart.

Let me—I think maybe I'll give you a little—talk a little bit about the intellectual history of the flat tax. We have my formal testimony available for the record.

The flat tax was first conceived at the Hoover Institute by Professors Hall and Rabushka in 1984. In fact, I ran on the flat tax in my first race for Congress in 1984. And the—there was a fervor, as you know, for tax reform that went to 1986, and, at that point, since many people thought the 1986 bill either represented the fact that the job was done or that the job was hopeless—I'm not sure which conclusions were drawn—tax reform, at least at that level of interest, seemed to wane. In 1994, I rehabilitated the original Hall-Rabushka idea and reintroduced it in Congress, along with Senator Shelby, and we've worked around that, as you know. Then it's become a matter of issue in Presidential races with Steve Forbes and others.

It's—it was, in 1984, and remains today, a good idea that is proven out when it is applied. The idea of applying the notion to the District, as compared to the rest of the world—and I won't go into all of the chapter-and-verse details of the burden of the taxes, all that is very—will be in the record. I think, though, it is an intriguing idea, about applying in the District of Columbia.

Let me say that this would probably be the most comprehensive and effective enterprise zone legislation you could have for the District or for any other area. The fact that it is voluntary, I think, results in what could be the most difficult problem in its application for the District. And I should remind you that Delegate Eleanor Holmes Norton advanced this same idea about 10 years ago.

Let me first take the enterprise zone. The fact of the matter is, if you take the flat tax in its application as an option available to people who live in the District, obviously most anybody with a complex, befuddling, and, I dare say, risky tax filing—and I say that seriously, because the fact of the matter is, for most of us, even though we do our dead level best, we ask and obtain good advice, and we do our—an earnest effort to comply with the law, as you have pointed out, nobody, even in the IRS, can be 100 percent certain they understand the law, so that, indeed, we all live with the risk that we may inadvertently, after the first best rigorous good-faith effort, have made what somebody construes to be a mistake that would get us before the auditors; and, frankly, for most Americans, this is not a happy experience—in any event, most people, when given the option, I believe, will opt for the simplified form, largely because it just makes life safer and simpler; second, because it will lower their taxes, in most instances. Also, if you are—if you apply it to the business enterprise, when you throw in the two big innovations in the code as it relates to business, which is

expensing of capital and inventory, it becomes an enormous attraction for business.

So, the upshot of its application here in the District, I would argue, would be to attract many people back from the suburbs into the city—who make their living in the city—and to attract a good bit of business enterprise, particularly small-business enterprise, back into the city, and do what we have seen done effectively with enterprise zone legislation in other areas, in a large and significant—to a large and significant degree.

That argument, I think, is verified by watching the application of the tax in Eastern European nations after the fall of the Soviet empire. We have seen economic growth coming most quickly to those countries that most quickly went to the flat tax and set up their economy to be receptive for that. And other companies—countries now coming to the notion in order to catch up with the growth experiences they've seen. And very little is available to offer the different—an explanation for the different growth experiences of the different Eastern European countries, other than their tax structure. So, it seems to me there is a very good validation of the notion that the enterprise zone effect will work, and work well, for the District of Columbia.

The fact that it's voluntary is, I think, very important. I like to think, because I'm such a fan of the big—of the flat tax, that I'd like to couch it in terms of those: those who are foolish may choose to stay with the old system. That's not altogether fair. Given the fact that so much of income maintenance is transferred to the American people through the Tax Code in such things as income tax credits of a variety of forms, it can appear that lower-income people, who are accustomed to taking their income transfer from the Federal Government in the form of the tax credits, might very well opt to stay with the old Tax Code. Unless there was an also attendant piece of legislation that alternatively provided for those same transfers to these people who are currently enjoying the tax credits, I believe that you would find that you would have less than a full participation in the flat tax, because the best, most rational reason for a person to stay with the old Tax Code would be to enjoy those income transfers not available under the flat tax. I would say, though, that that pretty well would define the population of people who would opt to stay with the old Code. I see no—as I've studied the code and the contrast of the two, I see no good reason.

There are many myths about the existing Tax Code, that, for example, if you own a mortgage, you will lose. I promise you, most mortgage holders find they're better off with the flat tax than with a mortgage. We can talk about that later. One thing I do, again, want to say, it is voluntary. That's a good thing.

My final observation, Mr. Chairman, would be that should you succeed in having this opportunity available to the citizens of the District of Columbia, you're going to have a tough time explaining to the citizens of Manhattan, Kansas, "Why them and not us?" Because I think it will be observed, appreciated, and recognized as a great benefit to the citizens of this city.

Senator BROWNBACK. Well, that's why I've offered to have two pilots on this. We could do it in Washington, DC, and Kansas, just to pick a random State out that would be another one to provide

this option to. But this is a particularly unique situation with the Federal District here. And so, I wanted to try and offer it here.

Thanks, Congressman Armey, appreciate seeing you, appreciate you being back.

[The statement follows:]

PREPARED STATEMENT OF RICHARD K. ARMEY

Good afternoon Mr. Chairman and Members of the committee. I am Dick Armey, former House Majority Leader, and currently Co-Chairman of FreedomWorks, a nonpartisan, nonprofit grassroots organization with more than 700,000 members that works for lower taxes, less government, and more freedom. Thank you for inviting me here today to discuss a flat federal income tax for the residents of Washington, DC.

This is an opportunity to bring to the residents of Washington, DC, the benefits of fundamental tax reform that Eleanor Holmes Norton had hoped to bring to the District 10 years ago when she introduced a similar bill. She realized the economic growth such reform would offer the city. It is an opportunity to bring to the residents of Washington, DC, the benefits we should eventually bring to the whole country. Currently residents in nine countries around the world enjoy the benefits of a flat tax, and many other countries are considering this approach, from the United Kingdom, to Germany, to China.

A flat income tax is fair, honest, simple, and pro-growth. That is what the American people want. They know that our current income tax system is broken. It is complex, it is unfair, it inhibits savings, investment and job creation, it imposes a heavy burden on families, and it undermines the integrity of the democratic process. It cannot be repaired by any tinkering or fine-tuning. It must be completely repealed and replaced with a flat income tax. While we should do this on a nationwide basis, doing so for the District of Columbia is a good start.

Under a flat tax, like in the Armey-Shelby flat tax bill introduced as recently as the 107th Congress, all income is taxed once and at one rate. Wage and pension income tax is collected from individuals. All other income tax, including investment income tax, is collected from businesses. Individuals fill out a tax return the size of a postcard. Business owners pay the same tax rate on profit (revenue minus expenses) and would file an equally straightforward tax form.

To achieve the highest level of simplicity and fairness, all deductions and credits should be eliminated. The only exception in most proposals is for a generous personal exemption that every American would receive. For a family of four, for example, the first $40,000 in income could be exempt from tax. The personal deduction amount (which should be indexed to inflation) and the flat tax rate should be calculated to be revenue neutral, so as to not increase the deficit in the process of enacting this important reform.

The flat tax is pro-family. It contains no marriage penalty and can be constructed to nearly double the deduction for dependent children. By ending the multiple taxation of saving, the flat tax provides all Americans with the tax equivalent of an unlimited IRA. This will make it easier for families to save for a home, a vacation, a college education, or retirement. The flat tax replaces the current income tax system, but does not affect the Social Security and Medicare payroll taxes.

With a flat tax, there are no breaks for special interests. No loopholes for powerful lobbies. Just a simple tax system that treats every American the same. The flat tax would simplify the tax code, promote economic opportunity, and restore fairness and integrity to the tax system—all problems in the current system that need correcting, as I will detail in these next paragraphs.

Current Tax Code Problems and the Flat Tax Solution

The Current Problem: Complexity

The residents of Washington, DC, alone spend over 12 million hours completing their taxes. This is because the U.S. income tax code is unnecessarily complex; it is a monument to unnecessary waste. The IRS sends out eight billion pages of forms and instructions each year which, if laid end to end, would circle the earth 28 times. Nearly 300,000 trees are cut down each year to produce the paper on which IRS forms and instructions are printed. The code exceeds 60,000 pages, and it takes Americans 6.6 billion hours to complete their taxes every year, which is more time than it takes to build every car, truck, and van produced in the United States. It now takes an average of over 26 hours to file a standard 1040 and over 60 percent of Americans turn to professional help to file their taxes. Simply complying with the tax code imposes national costs as high as $194 billion annually. That comes to

about $650 for every man, woman, and child in America, or a cost of about $360 million on the people of Washington, DC alone.

The Flat Tax Solution: Simplicity

The flat tax replaces the current income tax code and its maze of exemptions, loopholes, and targeted breaks with a system so simple Washingtonians could file their taxes on a postcard-size form. It has been estimated that a flat tax would reduce compliance costs by 94 percent, saving Washington DC taxpayers as much as $334 million in compliance costs each year. That's money that could be saved, invested, or spent at businesses in Washington.

The Current Problem: Unfair

The main reason the tax code is so complex is the proliferation of deductions, credits, and other special preferences in the tax law. Because of these loopholes, taxpayers with similar incomes living next to each other, or in different parts of Washington can pay vastly different amounts in taxes. This uneven treatment of taxpayers is fundamentally unfair and is at odds with the American value of equality under the law.

The Flat Tax Solution: Fairness

The flat tax will restore fairness to the tax law by treating everyone the same. No matter how much money you make, what kind of business you are in, whether or not you have a lobbyist in Washington, you will be taxed at the same rate as every other taxpayer.

However, by incorporating a large personal deduction, progressivity is maintained. This is what led D.C. Delegate Eleanor Holmes Norton to call her proposal a "uniform tax" rather than a "flat tax" which she felt incorrectly implied that is was not progressive. Under the flat tax, or uniform tax, the more you earn, the more you pay. In fact, because of the high family exemption, the more a taxpayer earns, the greater the share of his income he pays in tax. A family of four earning $25,000 would owe no tax under a proposal like the Armey-Shelby flat tax. A family of four earning $50,000 would pay only 6 percent of its income in income taxes while a family earning $200,000 would pay 14 percent. But they would all have the same personal deduction, and the same rate on income above that deduction.

The Current Problem: Hindering Economic Opportunity

The tax code reduces incomes through punitive taxes on saving, work, and entrepreneurship. It places multiple layers of taxation on saving, thus reducing investments in new machines and technology that make Washington's workers more efficient and competitive. High marginal tax rates (that is, the tax rate on the last dollar earned) discourage work, saving, and entrepreneurial activity, which leads to a smaller and less productive economy. By favoring certain economic activities over others, the tax code distorts financial decisions and reduces economic efficiency. Dale Jorgenson, the chairman of the Economics Department at Harvard University, found that each extra dollar the government raises through the current system costs the economy $1.39.

The Flat Tax Solution: Prosperity

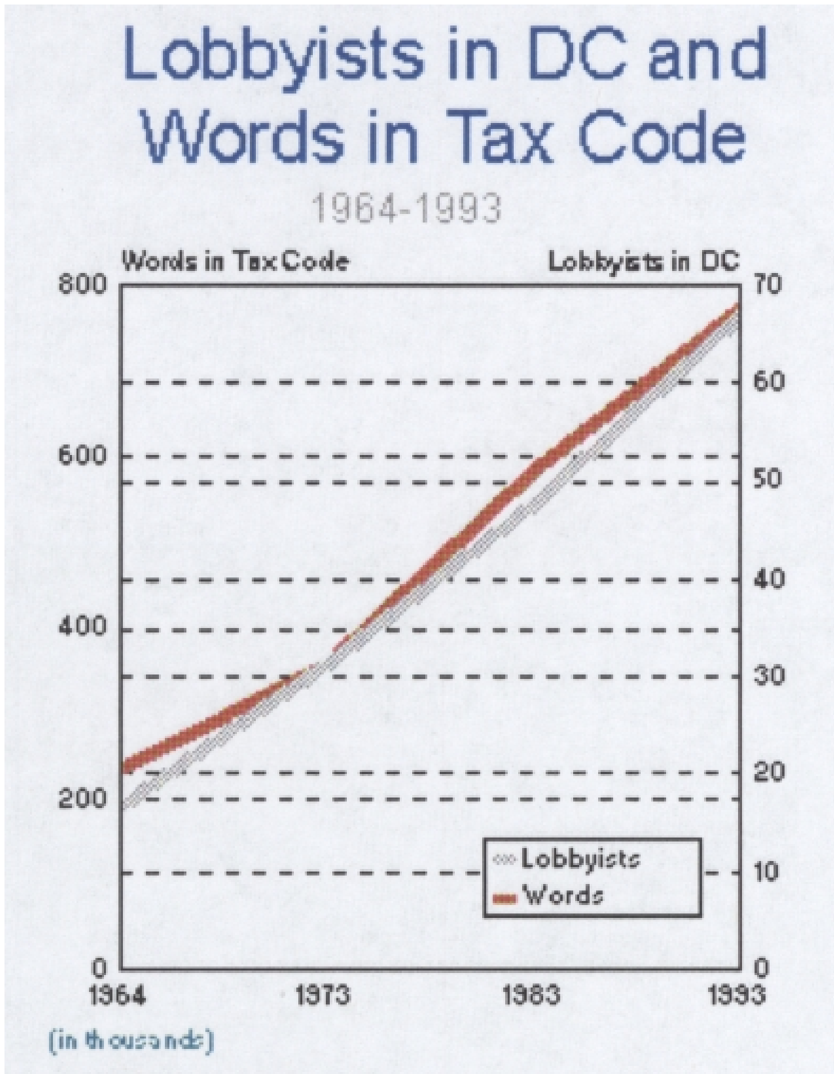
Because the flat tax treats all economic activity equally, it will promote greater economic efficiency and increased prosperity. When saving is no longer taxed twice, people will save and invest more, leading to higher productivity and greater take-home pay. When marginal tax rates are lower, people will work more, start more businesses, and devote fewer resources to tax avoidance and evasion. And because tax rules will be uniform, people will base their financial decisions on common-sense economics, not arcane tax law.

The calculations that have been done to estimate the national benefits of a flat tax can be very roughly recalculated to figure out how much better off Washington, DC, would be. However, these numbers may be low since the barriers to capital and individual movement within the United States to a flat tax area like Washington, DC are so much less than the barriers to such movements from other nations to a flat tax United States, which is on what the initial estimates are based.

According to one study by a former chief economist for Congress' Joint Committee on Taxation, under the flat tax the economy would be 5.7 percent larger after five years than under the current system. That translates into over $500 billion in higher output—or roughly $927 million for Washington, DC. That's more than $3,000 in higher income for the typical family of four. Michael Boskin, a former chairman of the Council of Economic Advisors, estimates that the flat tax would increase the size of the economy by 10 percent.

The Problem: Undermining Good Governance

The current tax code does more than complicate people's lives during tax season and reduce living standards. It pollutes Washington's political culture. As special-interest provisions have been added to the tax code, Washington's lobbying industry has flourished. The accompanying chart shows how the growth of the lobbying industry has coincided with the increased number of words (and special-interest provisions) in the tax code.



Washington's lobbying industry is the largest private employer in the nation's capital. If the lobbying industry were its own economy, it would be larger than the economies of about 60 countries. Since 1998, 483 companies have lobbied the IRS alone, hiring 2,884 tax lobbyists, including 277 former federal government employees. While the thousands of lobbyists in Washington have prospered in an environment of tax favoritism, the typical taxpayer has not.

While offering a flat tax to Washington DC alone would have little impact this problem, but it could be argued that a nation-wide flat tax would virtually eliminate

Washington's tax lobbying industry, which would be a blow to Washington's economy, but a repercussion about which few Americans would complain.

The Flat Tax Solution: Transparency

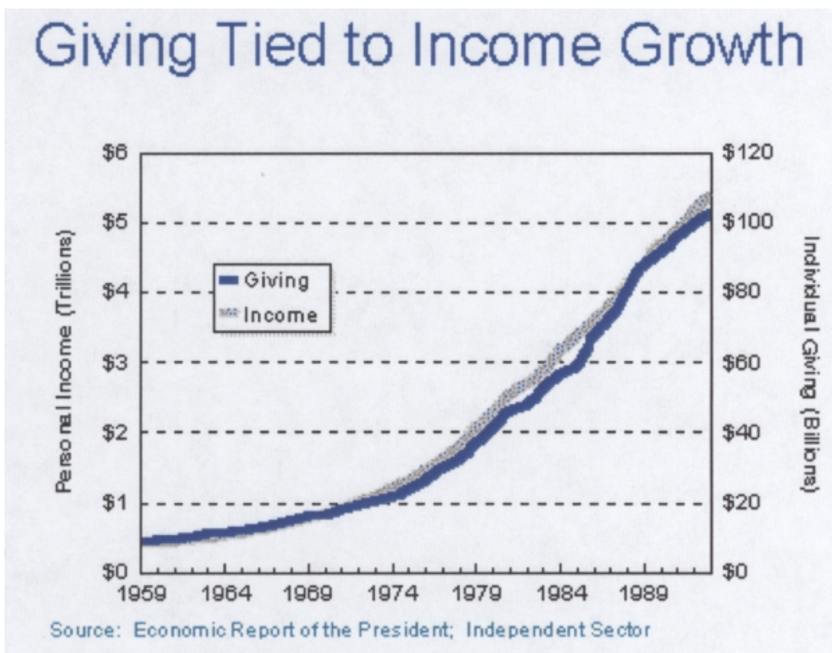
By eliminating itemized deductions and special breaks, the flat tax would have a chilling effect on special-interest lobbying and transform the political culture in Washington. Under a simple, transparent system that taxes all income one time—and requires a supermajority vote to add a loophole—there will be far fewer lobbyists than under today's special-interest, free-for-all tax system.

Frequently Asked Questions

Many D.C. residents find the flat tax to be a powerful and liberating idea. They like the fact that it is in line with the fundamental American understanding that everyone should be treated equally before the law. Of course, any major change leads even the strongest supports to ask questions like the following:

Won't charities suffer as a result of the flat tax?

No. As incomes rise under the flat tax, so, too, will donations to America's charities. As the nearby chart shows, over the past several decades, increases in giving have closely tracked increases in personal income. This trend continued even during the 1980s when the tax value of the deduction declined and fewer taxpayers were able to take the charitable deduction. Because incomes will increase significantly under the flat tax, giving will rise in the long run as well, even without the charitable deduction.



But is the flat tax progressive?

Sure it is, because of the generous family allowances—the only deduction that should be allowed. In the Armey-Shelby flat tax bill, the first $33,300 of income for a family of four was exempt—about $40,000 in today's dollars. As a result, middle-income people would pay a far lower share of their income in taxes than the rich, and the poor would pay nothing at all. Think about it. If a family of four makes $50,000 under the Armey-Shelby flat tax, the 17 percent flat-tax rate applies to less than a third of that family's income. But if a family of four makes $200,000, the 17 percent flat tax rate applies to 80 percent of that family's income.

But even if the flat tax didn't have this progressive feature, the rich would still pay a lot more in taxes than the middle class or the poor. With three times the net

income (after taking out your personal exemption) you would pay three times the taxes. And so on. That seems pretty fair to me.

Would the family allowance be indexed for inflation?

If the proposal for D.C. is similar to the Armey-Shelby proposal, yes.

Will the flat tax increase taxes on the middle class?

No. Washingtonians at all income levels will have their taxes reduced. Not only will taxpayers keep more of their money, but their incomes will increase. Under the flat tax, the typical family will see its income rise by $5,000 to $7,000 within five years.

I've heard the flat tax doesn't tax investors' income. Is this true?

No, that is flat wrong. The flat tax taxes all income at the same rate, whether it comes from wages, stock dividends, or some other source.

How will the flat tax affect pensions, 401(k)s, and other retirement plans?

Because the flat tax ends the bias against saving, in effect, all income that is saved will be treated like an IRA or a pension. Currently, IRAs, 401(k)s, and pensions are unusual because they are taxed only once. Under the flat tax, all savings will be taxed only once. That will make it easier for Americans to save for their children's education, their own retirement, or anything else.

Conclusion

The flat tax is so popular with the American people, and so many Washingtonians, because it embraces the core belief that all Americans should be treated equally. Rich or poor, black or white, we should all be viewed equal before the law. No more favoritism toward some citizens and harassment of others. No more loopholes. No tax breaks for corporations. No tax shelters. No depreciation schedules. No tables. Nothing.

Instead of sending out pages and of pages of forms each year, the IRS would need to send out just one post card to every taxpayer. Washington's taxpayers would be spared more than 12 million hours of compliance time as they would be able to fill out their tax form post card in minutes. Everyone would make the same simple calculation: income, minus personal deduction, times tax rate. That's it.

The simplicity and fairness would further the economic renaissance Washington, DC has seen over the past 10 years. The estimated $927 million in higher economic output in Washington over the first five years of the flat tax would go a long way toward bringing the city's increased prosperity to every corner of the nation's capital.

Thank you.

STATEMENT OF DANIEL J. MITCHELL, McKENNA SENIOR FELLOW IN POLITICAL ECONOMY DOMESTIC POLICY STUDIES, THE HERITAGE FOUNDATION

Senator BROWNBACK. Dr. Mitchell, good to have you here, and would appreciate your thoughts and suggestions and advice on this.

Dr. MITCHELL. Well, thank you, Mr. Chairman.

With your permission, I'll just summarize a few of the points in my testimony and submit the rest for the record.

I want to touch on a couple of, I guess, theoretical points, but then focus most of my remarks on some of the practical issues, some of the real-world evidence that surrounds tax reform.

And probably the number one thing to start with is to keep in mind that we live in a globalized economy today. It is so much easier than it's ever been for jobs and capital to cross borders. This is one of the reasons why a District of Columbia flat tax would be such a great pilot program, because we would see so much faster growth, so many new jobs being created in the District of Columbia, that the rest of the country would put a lot of pressure on Congress, and I think we would break through the special-interest logjam and finally get fundamental tax reform if we had it in one jurisdiction. And the District of Columbia, of course, would be an

ideal place to start it, because it truly is, as Congressman Armey mentioned, the enterprise zone of all enterprise zones.

But, of course, this also applies internationally, not just inside the United States. We have seen—and I'll talk about this a little bit later—some of the countries that have put in place flat taxes, how revenues have gone up for government, how economic growth has boomed, how jobs have been created, how investment is flooding in. These are all positive things that maybe 20 years ago we didn't really have that much evidence to talk about. We had Hong Kong, but, for some reason, people wanted to say Hong Kong's a special case. I never understood why it was a special case. It showed that low taxes and a light burden of government frees up the entrepreneurial energy of people and leads to incredibly rapid economic growth.

Let me just talk about some of the key principles of what you find in a flat tax.

A low tax rate. Why a low tax rate? Because taxes are a price. Lawmakers across the country understand this when they're talking about tobacco taxes. "We need to raise tobacco taxes to discourage people from smoking." Now, whether that's the right job of government to do, the economic analysis is correct. The higher the tax rate, the less you get of whatever's being taxed. Let's apply that same lesson to work, saving, investment, risk-taking, and entrepreneurship. We want a low tax rate on those things, because those are the things that create wealth, create jobs, and build a more competitive country. So, principle one is, you want the tax rate as low as possible.

Second big principle: don't double tax savings and investment. If you earn money, pay tax on it, and you then decide to save and invest it, you shouldn't be hit with extra discriminatory layers of taxation simply because you save and invest. And, unfortunately, under our current tax system, between the capital gains tax, the corporate income tax, the personal income tax, and the death tax, you can have a single dollar of income taxed four different times. So, even if you get the rate low, but if you cycle the dollar through the Tax Code four times, the effect of marginal tax rate can be very high. And this is especially foolish. Every economic theory, even Marxism and socialism, they all agree that capital formation is really a prerequisite for a long-run economic growth and higher living standards. And yet, we reserve the very highest tax rates in our system for the people who are setting aside the seed corn of savings and investment for future economic growth.

And then, of course, you want a simple system that gets rid of all the special preferences and penalties. We don't want industrial policy through the Tax Code—or at least we shouldn't want that—if we want people to make decisions on the basis of market factors, what's going to create the most wealth, as opposed to political factors. You can—with the Tax Code, you could encourage people to build factories that make candy bars that taste like onions. There's no doubt in my mind. You could do that through the tax system. But would it make sense? Wouldn't it be better to have that capital being invested in ways that actually generate long-run economic growth? And what a flat tax does is, by stripping out all the special-interest clutter in the tax system, we actually have a system

that not only lowers compliance costs—you know, the $200 odd billion that people have to pay for tax lawyers, accountants, lobbyists, preparation, man hours—all that goes away. But perhaps an even bigger number, which is harder to calculate, I'll admit, is the notion that people are going to start making decisions solely on the basis of what's good for the economy, and that's going to generate much, much better economic performance.

And probably the thing to focus on is, what have we actually seen in the countries that make those decisions? Ever since the collapse of the Soviet empire, we have seen now 10 countries—because we just have Kyrgyzstan—I had to look it up on the map—Kyrgyzstan just joined the club a couple—less than 1 month ago. But we have the three Baltic countries of Lithuania, Latvia, and Estonia, we have Slovakia, Ukraine, Russia, Georgia, Romania, Kyrgyzstan—I should probably cheat on the—look on the list there—Serbia—make sure I'm not missing one. If you look at the results in those countries, it's truly remarkable. The three Baltic countries are now known as the "Baltic Tigers." They've already made all the requirements for joining the European Union, which means they're developed countries, a remarkable period of growth following the adoption of flat taxes, and, to be fair, lots of other market-oriented policies.

The whole world—you know, notwithstanding my view on things, I realize the whole world doesn't revolve around taxes. But a good tax system is a precondition for rapid economic growth. And the countries that put in those flat taxes the longest period ago, back in the mid 1990s for the Baltics, have certainly grown the fastest. But even if you look more recently—Russia did a flat tax effective January 1, 2001. What's happened? They've got strong economic growth. Some of it's due to oil prices, of course, but it's especially interesting to see what's happened to personal income tax revenues. In less than—in just 4 years, personal income tax revenues, even after adjusting for inflation, have gone up by more than 100 percent. Why? Two factors. One, when your tax rate is very low, your incentive to evade the system falls dramatically. I mean, if you're paying 30 percent, your incentive to cheat is a lot higher than if you're paying 13 percent. And I will note that former communists came up with a flat tax four points lower than the former House majority leader was able to propose, which——

Senator BROWNBACK. I always had questions about Dick Armey——

Mr. ARMEY. The communists didn't have CBO scoring, or I'd have been there.

Dr. MITCHELL. Slovakia is another great example. They probably have one of the purest flat taxes out there, most closely related to the Hall-Rabushka proposal that was embedded in the proposal of Congressman Armey's. And Slovakia has just had an enormous increase in foreign direct investment, an enormous increase in jobs, and their economy is doing very well. Again, income tax revenues are above the projections.

And we even have international bureaucracies, like the IMF and the World Bank, now writing papers and studies trumpeting the Slovakian flat tax. They weren't that sympathetic when it was being debated. But even they, who are normally more on the left

of center, have recognized that this has been a great proposal, a great reform, to help create more jobs and lift people out of poverty.

And then countries after countries—we're going to probably see Slovenia do a flat tax this year. We're probably going to see Kazakhstan do a flat tax this year.

The question is—we now have a reverse Iron Curtain. We need the flat tax to come to the west. We need it to come to America. And I think the D.C. flat tax, building upon all this real-world evidence that we see—we know lower taxes work, and we know simpler tax systems work—I hope the D.C. flat tax could be the impetus for bringing this simple and fair system to America.

Thank you.

Senator BROWNBACK. Thank you very much, Dr. Mitchell. Thanks for the thoughts.

[The statement follows:]

PREPARED STATEMENT OF DANIEL J. MITCHELL

My name is Daniel Mitchell. I am the McKenna Senior Fellow in Political Economy at The Heritage Foundation. The views I express in this testimony are my own, and should not be construed as representing any official position of The Heritage Foundation.

There is widespread consensus that the current tax system is a complicated failure that hinders the nation's growth while allowing the politically well-connected to manipulate the system to get special breaks that are not available to average workers and businesses. This is stimulating a great deal of interest in shifting to a simple and fair flat tax.

The United States should move quickly to reform its tax system. In a competitive global economy, jobs and capital flow to jurisdictions with better tax law. Traditionally, this process of "tax competition" has benefited the United States, but there is growing evidence that America is falling behind. Nations around the world are lowering tax rates and reforming their tax systems. Indeed, ten countries that were part of the former Soviet Bloc have adopted versions of the flat tax. These pro-growth reforms are yielding impressive results and are a road map for U.S. policymakers.

Adopting a flat tax for the District of Columbia would be an added impetus for reform. Many policy makers want to dismiss Eastern European flat tax regimes. They also have ignored the Hong Kong flat tax, even though it has been a remarkable success for almost six decades.

A flat tax in the District of Columbia would not be so easy to overlook. The economic renaissance would become a national case-study. Improved incentives for work, saving, and investment would create a laboratory for supply-side economics. There would be a significant influx of jobs and investment, and other states—especially neighboring jurisdictions—quickly would clamor for a similarly attractive tax code.

Indeed, this is the reason why a flat tax for the District is desirable. Traditionally, economists do not like tax systems that create unequal treatment. And there is no question that a geographically restricted flat tax would discriminate against those in other parts of the country.

But the perfect should not be the enemy of the good. The internal revenue code is riddled with discriminatory provisions. People are treated different based on the source of their income, the use of their income, and the level of their income. So if a geographically-based flat tax is the "camel's nose under the tent" for adoption of a flat tax for all Americans, then the short-run inequity would be more than offset by long-run prosperity and equality for the entire nation.

What Is a Flat Tax?

Unlike the current system, a flat tax is simple, fair, and good for growth. Instead of the 893 forms required by the current system, a flat tax would use only two postcard-sized forms: one for labor income and the other for business and capital income. Unlike the current system, which discriminates based on the source, use, and level of income, a flat tax treats all taxpayers equally, fulfilling the "equal justice under law" principle etched above the main entrance to the U.S. Supreme Court building. And unlike the current system, which punishes people for contributing to the nation's wealth, a flat tax would lower marginal tax rates and eliminate the tax bias

against saving and investment, thus ensuring better economic performance in a competitive global economy.

There have been several flat tax proposals over the years, all of them based on the path-breaking proposal developed by two Hoover Institution economists. While no two plans are identical, they all share common features that fix the major flaws of the current Internal Revenue Code. Simplicity and fairness are also natural consequences of these component features of tax reform.

These major features of a flat tax are:

A Single Flat Rate.—All flat tax proposals have a single rate, usually less than 20 percent. The low, flat rate solves the problem of high marginal tax rates by reducing penalties against productive behavior, such as work, risk taking, and entrepreneurship.

Elimination of Special Preferences.—Flat tax proposals would eliminate provisions of the tax code that bestow preferential tax treatment on certain behaviors and activities. Getting rid of deductions, credits, exemptions, and other loopholes also helps solve the problem of complexity, allowing taxpayers to file their tax returns on a postcard-sized form.

No Double Taxation of Saving and Investment.—Flat tax proposals would eliminate the tax code's bias against capital formation by ending the double taxation of income that is saved and invested. This means no death tax, no capital gains tax, no double taxation of saving, and no double tax on dividends. By taxing income only one time, a flat tax is easier to enforce and more conducive to job creation and capital formation.

Territorial Taxation.—Flat tax proposals are based on the commonsense notion of "territorial taxation," meaning that governments should tax only income that is earned inside national borders. By getting rid of "worldwide taxation," a flat tax enables U.S. taxpayers and companies to compete on a level playing field around the world.

Family-Friendly.—All flat tax proposals have one "loophole." Households receive a generous exemption based on family size. For instance, a family of four would not begin to pay tax until its annual income reached more than $30,000.

Consumption-Based.—A tax code that does not discriminate against saving and investment is considered a consumption-based tax system, regardless of whether taxes are deducted from the paycheck or collected at the cash register. In this respect, a flat tax is a type of consumption tax. The difference between a flat tax and a national sales tax is where the tax is collected. A flat tax is levied on income—but only once and at one low rate—as it is earned. A sales tax is levied on income—but only once and at one low rate—as it is spent.

Both the flat tax and the sales tax differ dramatically from the U.S. Internal Revenue Code. The current tax code has numerous forms of double taxation, such as its treatment of saving and corporate income. The current tax code also has several forms of wealth taxation or asset taxation, such as the capital gains tax and the death tax. (These also are forms of double taxation since the assets were acquired with after-tax dollars.) The current tax code even has provisions that force taxpayers to overstate their income, such as forcing businesses to "depreciate" the cost of new investment instead of allowing immediate and full deduction (a policy known as "expensing") when costs are incurred.

None of these forms of double taxation, wealth taxation, or overtaxation exist in either a flat tax or a national sales tax, which is why public finance economists categorize both systems as consumption-based taxes.

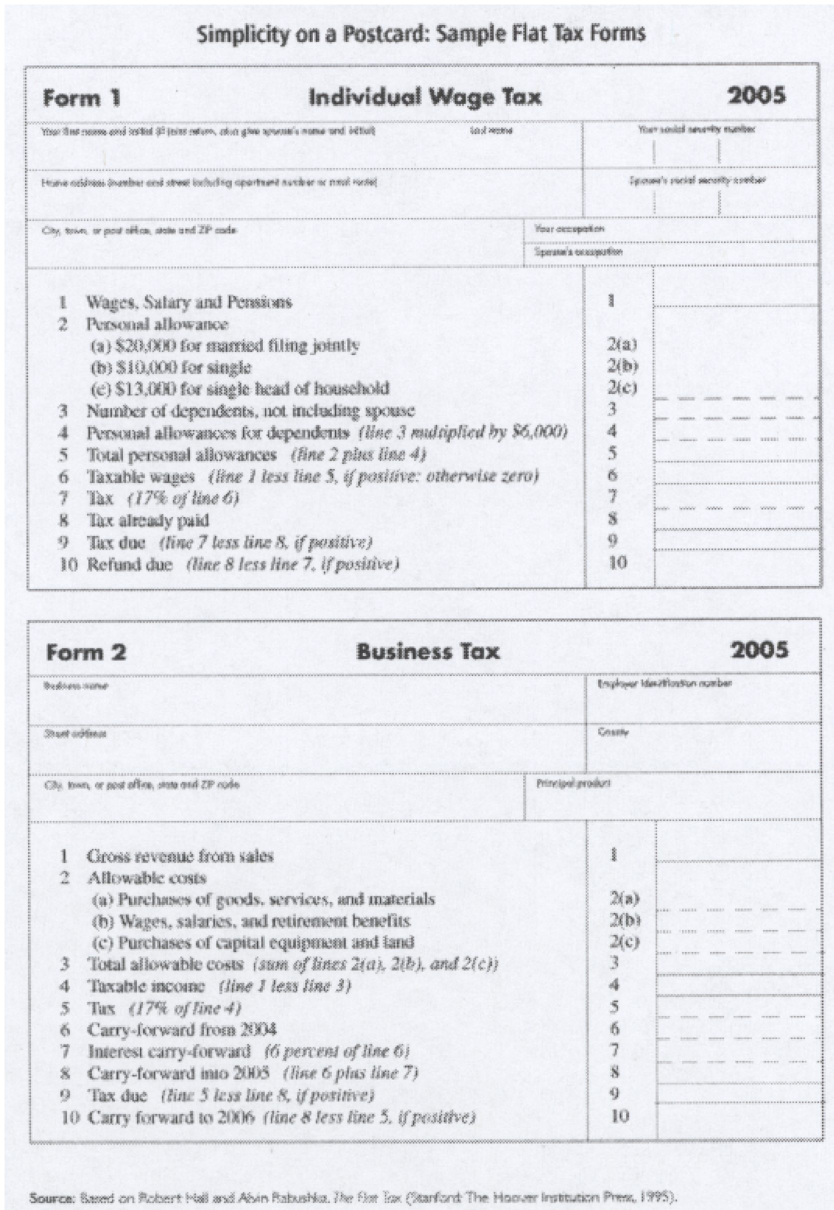
How a Flat Tax Would Work for Individual Taxpayers

Compared to the current system, a flat tax is extremely simple. Households pay tax on their labor income using a 10-line individual postcard. (See Form 1 in Figure 1.) They do not need to worry about reporting dividends, interest, and other forms of business/capital income. Those forms of income are taxed at the business level, thus obviating any need to tax them at the individual level since that would violate the principle of no double taxation.

The individual postcard is so simple that a third-grader could file a family's tax return in about five minutes. Each household would report wage, salary, and pension income on Line 1, which should be easily available from W–2 forms. Using Lines 2–5, the household then would calculate its personal allowance, which is based on family size. The personal allowance on Line 5 is then subtracted from Line 1 to determine taxable income. This amount is reported on Line 6. The amount of tax is calculated on Line 7. This amount is then compared to the amount of tax withheld on Line 8, which then leaves either a tax payment (Line 9) or a refund (Line 10).

How a Flat Tax Would Work for Businesses

Like the individual postcard form, the business postcard form is very simple. (See Form 2 in Figure 1.) All businesses, from Microsoft to a hot dog stand, would play by the same rules. There no longer would be separate tax rules for partnerships, sole proprietorships, S corporations and regular corporations. All business operations in America, whether owned by a U.S. company or owned by a foreign company, would pay tax on the income that they earn in the United States.



Simplicity on a Postcard: Sample Flat Tax Forms

Form 1 **Individual Wage Tax** **2005**

Your first name and initial (if joint return, also give spouse's name and initial) | Last name | Your social security number

Home address (number and street including apartment number or rural route) | Spouse's social security number

City, town, or post office, state and ZIP code | Your occupation | Spouse's occupation

1	Wages, Salary and Pensions	1
2	Personal allowance	
	(a) $20,000 for married filing jointly	2(a)
	(b) $10,000 for single	2(b)
	(c) $13,000 for single head of household	2(c)
3	Number of dependents, not including spouse	3
4	Personal allowances for dependents *(line 3 multiplied by $6,000)*	4
5	Total personal allowances *(line 2 plus line 4)*	5
6	Taxable wages *(line 1 less line 5, if positive: otherwise zero)*	6
7	Tax *(17% of line 6)*	7
8	Tax already paid	8
9	Tax due *(line 7 less line 8, if positive)*	9
10	Refund due *(line 8 less line 7, if positive)*	10

Form 2 **Business Tax** **2005**

Business name | Employer Identification number

Street address | County

City, town, or post office, state and ZIP code | Principal product

1	Gross revenue from sales	1
2	Allowable costs	
	(a) Purchases of goods, services, and materials	2(a)
	(b) Wages, salaries, and retirement benefits	2(b)
	(c) Purchases of capital equipment and land	2(c)
3	Total allowable costs *(sum of lines 2(a), 2(b), and 2(c))*	3
4	Taxable income *(line 1 less line 3)*	4
5	Tax *(17% of line 4)*	5
6	Carry-forward from 2004	6
7	Interest carry-forward *(6 percent of line 6)*	7
8	Carry-forward into 2005 *(line 6 plus line 7)*	8
9	Tax due *(line 5 less line 8, if positive)*	9
10	Carry forward to 2006 *(line 8 less line 5, if positive)*	10

Source: Based on Robert Hall and Alvin Rabushka, *The Flat Tax* (Stanford: The Hoover Institution Press, 1995).

All business taxpayers would put their total receipts on Line 1. They would then add together their labor costs, their input costs, and their investment costs on Lines 2 and 3. These costs are subtracted from gross receipts to determine taxable income on Line 4. Line 5 is the amount of tax that is due. Lines 6–10 exist in case a company either had losses from previous years and now has an opportunity to offset taxable income or has losses this year and needs to "carry them forward" to the next tax year.

How a D.C. Flat Tax Would Work

Administering a geographically-targeted flat tax poses some challenges. In a modern economy, cross-border economic activity is very common. Would that activity be taxed under the D.C. flat tax, or in another state under the rules of the current internal revenue code? Would the flat tax only apply for those who reside in the District? Would the flat tax apply to businesses, or just to individuals? And if it applies just to individuals, would some of the policies outlined by Professors Hall and Rabushka—such as taxation of fringe benefits—be implemented?

These are genuinely difficult issues. To minimize the obstacles, policy makers may want to focus on the easiest approach—which would be a flat tax for resident individuals. Such an approach would not be as beneficial as a comprehensive flat tax applying to all individuals and businesses, but such legislation would still achieve the goals of boosting economic growth in the District of Columbia and creating a successful example that would spur fundamental tax reform for the entire nation.

The Advantages of a Flat Tax

There are two principal arguments for a flat tax—growth and fairness. Many economists are attracted to the idea because the current tax system, with its high rates and discriminatory taxation of saving and investment, reduces growth, destroys jobs, and lowers incomes. A flat tax would not eliminate the damaging impact of taxes altogether, but by dramatically lowering rates and ending the tax code's bias against saving and investment, it would boost the economy's performance when compared with the present tax code.

However, the most persuasive feature of a flat tax for many Americans is its fairness. The complicated documents, instruction manuals, and numerous forms that taxpayers struggle to decipher every April would be replaced by a brief set of instructions and two simple postcards. This radical reform appeals to citizens who not only resent the time and expense consumed by filing their own tax forms, but also suspect that the existing maze of credits, deductions, and exemptions gives a special advantage to those who wield political power and can afford expert tax advisers.

If enacted, a flat tax would yield major benefits to the nation, including:

Faster Economic Growth.—A flat tax would spur increased work, saving, and investment. By increasing incentives to engage in productive economic behavior, it would also boost the economy's long-term growth rate. Even if a flat tax boosted long-term growth by only 0.5 percent, the income of the average family of four after 10 years would be as much as $5,000 higher than it would be under current tax laws.

Instant Wealth Creation.—According to Harvard economist Dale Jorgenson, tax reform would boost national wealth by nearly $5 trillion. It would do this in part because all income-producing assets would rise in value since the flat tax would increase the after-tax stream of income that they generate.

Simplicity.—Complexity is a hidden tax amounting to more than $100 billion. This is the cost of tax preparation, lawyers, accountants, and other resources used to comply with the Internal Revenue Code. The Internal Revenue Service even admits that the current tax code requires taxpayers to devote 6.6 billion hours each year to their tax returns. Yet even this commitment of time is no guarantee of accuracy. The code is so complex that even tax experts and the IRS often make mistakes. All taxpayers, from General Motors to a hamburger-flipping teenager, would be able to fill out their tax return on a postcard-sized form, and compliance costs would drop by tens of billions of dollars.

Fairness.—A flat tax would treat people equally. A wealthy taxpayer with 1,000 times the taxable income of another taxpayer would pay 1,000 times more in taxes. No longer would the tax code penalize success and discriminate against citizens on the basis of income. Tax burdens would no longer depend on the number of lawyers, lobbyists, and accountants on the payroll.

An End to Micromanaging and Political Favoritism.—A flat tax gets rid of all deductions, loopholes, credits, and exemptions. Politicians would lose all ability to pick winners and losers, reward friends and punish enemies, and use the tax code to impose their values on the economy. Not only does this end a major source of political corruption, but it is also pro-growth since companies would no longer squander re-

sources lobbying politicians or making foolish investments just to obtain favorable tax treatment.

Increased Civil Liberties.—Under current law, people charged with murder are presumed innocent and thus have more rights than taxpayers dealing with the Internal Revenue Service. By contrast, a flat tax would eliminate almost all sources of conflict between taxpayers and the government. Moreover, infringements on freedom and privacy would fall dramatically since the government would no longer need to know the intimate details of each taxpayer's financial assets.

Economic Migration.—In addition to the aforementioned benefits, the District of Columbia would enjoy a substantial inflow of jobs and capital from the rest of the country. Indeed, economic migration might be the dominant effect when looking at the economics of a geographically-targeted flat tax. Similar migration (albeit from other nations) would occur with a nationwide flat tax, of course, but the impact of economic migration would be particularly pronounced in the case of a D.C. flat tax since it is much easier to move across state borders than it is to move across national borders.

Real World Evidence

In a remarkable development, former communist nations are leading a global tax reform revolution. Estonia was the first to adopt a flat tax, implementing a 26 percent rate in 1994, just a few years after the collapse of the Soviet Union. The other two Baltic republics of the former Soviet Union enacted flat taxes in the mid-1990s, with Latvia choosing a 25 percent rate and Lithuania picking 33 percent. Along with other free-market reforms, the flat tax significantly improved economic growth, and the "Baltic Tigers" became role models for the region. Learning from its neighbors, Russia stunned the world by adopting a 13 percent flat tax, which went into effect in 2001.

The Russian flat tax quickly yielded positive results: The economy prospered, and revenues poured into government coffers since tax evasion and avoidance became much less profitable. The flat tax then spread to Serbia, which in 2003 chose a 14 percent rate. Slovakia hopped on the bandwagon the following year with a 19 percent flat tax, as did Ukraine, which chose a 13 percent tax rate. Earlier this year, Romania joined the flat tax revolution with a 16 percent tax rate, and Georgia adopted a 12 percent flat tax rate, which has the honor, at least temporarily, of being the lowest rate in the world.

The flat tax revolution has been so successful that Estonia is lowering its rate to keep pace with other nations. The Estonian flat tax is now down to 24 percent and will drop to 20 percent by 2007, and Lithuania is in the process of lowering its 33 percent flat tax to a more reasonable 24 percent. Poland's government just announced that it will implement an 18 percent flat tax, and lawmakers in Croatia, Bulgaria, and Hungary are also considering tax reform. Last but not least, the opposition parties in the Czech Republic have promised to implement 15 percent flat tax regimes if they win the upcoming elections.

In a global economy, it is increasingly easy for jobs and capital to escape high-tax nations and migrate to low-tax nations. This means that the reward for good tax policy is greater than ever before, but it also means that the penalties for bad policy are greater than ever before. This is why so many nations are lowering tax rates and reforming their tax systems. A flat tax will make America a magnet for investment and job creation.

Conclusion

The current income tax system punishes the economy, imposes heavy compliance costs on taxpayers, rewards special interests, and makes America less competitive. A flat tax would dramatically reduce these ill effects. Perhaps more important, it would reduce the federal government's power over the lives of taxpayers and get the government out of the business of trying to micromanage the economy.

There will never be a tax that is good for the economy, but the flat tax moves the system much closer to where it should be—raising the revenues that government demands, but in the least destructive and least intrusive way possible.

A D.C. flat tax should be seen as a means to an end. In the short run, some will accurately grouse that it creates an additional inequity in the tax code. They will complain that it will cause tax-motivated migration. They will fret that taxpayers will engage in arbitrage to benefit from better tax law in a specific part of the country.

These are all legitimate complaints, but they pay attention to the trees and forget about the forest. Fundamental tax reform has a great capacity to make America a freer and more prosperous nation. A D.C. flat could be the necessary prerequisite for the nationwide adoption of a simple and fair tax code.

Senator BROWNBACK. Mr. Edwards.

STATEMENT OF CHRIS EDWARDS, DIRECTOR OF TAX POLICY, CATO INSTITUTE

Mr. EDWARDS. Thank you very much, Mr. Chairman, for having me, and for these interesting and important hearings regarding a possible flat tax in the District of Columbia.

Last November, President Bush's bipartisan Advisory Panel on Federal Tax Reform sounded the alarm regarding the need for major reforms. The panel proposed two different reform plans that would simplify the Tax Code, cut marginal rates, and reduce taxes on savings and investment. What we're talking about here today, the flat tax that's long been championed by Mr. Armey and others, would create even far greater simplification than the President's Advisory Panel proposed. A flat tax would have one low rate, and treat savings and investment in a neutral and efficient manner.

On simplification, I must say that the problem is even more complex than you touched on with your stack of the Code and Federal regulations. There is, in addition to the Code and Federal regulations, thousands of pages of IRS rulings to guide taxpayers. There's thousands—tens of thousands, hundreds of thousands of pages of tax court cases. The Joint Committee on Taxation's report on Enron tax shelters was about 4 or 5 inches thick, just by itself. I believe the flat tax would eliminate a lot of that complexity, and it is one of the most important reasons for moving to a flat tax.

Despite recent tax cuts, the Federal income tax system is remarkably complex and efficient still. The top Federal income individual and corporate tax rates are, today, higher than they were following reforms in 1986 championed by Ronald Reagan, yet competition in the global economy is even more intense than it was a couple of decades ago, after 1986. The corporate tax rates, in particular, have been cut radically around the world since our leading reforms in 1986. We used to have one of the lowest corporate tax rates in the world. Now we've got one of the highest.

So, what sort of reforms should we pursue? Well, as Dan touched on, the countries of Eastern Europe have shown the way here. People have wondered about flat taxes—I mean, they've long been sort of an economist's dream, but we now know that they're a practical reality, as Dan touched on, in places like Russia and Slovakia.

In addition to the countries that Dan touched on, I mean, there's, you know—Estonia is—was the first to install a flat tax in—back in 1994, with a 26 percent rate. Hong Kong has long had a—what you can call a voluntary flat tax system. They've got a regular graduated rate system, but individuals, as an alternative, can chose to play—pay a 15 to 16 percent flat tax in Hong Kong. So, that would—is sort of a model for what we're talking about for the District of Columbia. Hong Kong, by the way, doesn't tax individuals on dividends and capital gains at all, as under the flat tax.

It's not just fairly small Eastern European economies that have radically cut their tax rates. The United States now has a much higher tax rate than the industrial countries of Western Europe, who are our main trading partners. And the average corporate tax rate across 25 European countries is now just 27 percent. We've got a 35 percent Federal tax rate. The average State tax rate's 5 to 6

percent. But some places, like New York City, have a 17 percent corporate tax rate on top of the Federal corporate tax rate, enormously inefficient. I would see little reason for major corporations to shift, you know, any of their activity to New York City, when you've got places like London, and even Paris, these days, with more lower corporate tax rates.

I think the countries around the world are going to continue to cut their corporate tax rates, because of the compelling benefits of attracting greater inflows of foreign investment. There's as much as $1 trillion a year in foreign direct investment that now crosses international borders. The United States is competing against many, many other countries these days for that investment, and it makes little sense to me that we have a tax system that repels investment rather than attracts it.

So, should we start reforms in our Federal tax system with a flat tax for the District of Columbia? Well, the first thing I would note is that the District of Columbia has a lot of reforms it could do on its own. It's got a 9 percent top tax rate for individuals, much higher than the 50-State average of 5½ percent. The District of Columbia has got a corporate tax rate of 10 percent, much higher than the 50-State corporate tax rate average of 6.9 percent. So, it makes sense, for me, if we were to go to a flat tax—a Federal flat tax in the District of Columbia, that any—the economic growth benefits, I think, would help fill the D.C. coffers, and the District of Columbia should use any extra economic—revenue from economic growth to lower its own corporate tax rates so that the Federal tax cuts don't just become a place for the District of Columbia to spend more taxpayer money.

I think a District of Columbia—a flat—a voluntary flat tax in the District of Columbia is a great idea. It would mean that no one would have to pay higher taxes under an alternative flat tax system. I must say that one possible issue are—at least on a static basis, are possible Federal revenue losses. I would argue that—it would be unpopular in the District of Columbia, but one way to deal with that problem is to cut Federal spending in the District, either their special District appropriations or just general Federal spending in the District, to create a revenue-neutral plan with lower taxes and lower spending in the District.

It seems to me if the District of Columbia—if you went to a tax system with a large revenue loss for the District of Columbia, neighboring States could complain. But, again, I think the solution would be to cut Federal spending in the District at the same time.

And it seems to me there's a parallel idea being proposed for Federal highway spending. Some bills have been introduced in Congress that would allow States who opt out of the Federal highway system—States could pay lower Federal gas taxes, but they wouldn't get Federal highway spending. So, in that sort of parallel, States could opt out and pay lower Federal taxes, but get lower Federal spending. And I think that there's a parallel argument that could be made for the District of Columbia.

A flat tax for the District of Columbia could include reforms to both individual and corporate taxes. I would say that, in general, corporate tax cuts have larger beneficial effects on the economy than individual tax cuts, although, in this case, both would be very

favorable. The Joint Committee on Taxation, last year, modeled the effects of a similar-sized corporate and individual income tax cut. They found that the long-run growth benefits of corporate tax cuts were much larger than individual tax cuts. So, I think the upshot for the District of Columbia is that a corporate tax cut would be highly beneficial, would give the biggest bang for the buck, would help create jobs and stronger growth in the District.

So, to conclude, the goal of Federal taxpayers should to, as the other panelists have said, replace the income tax, on a national basis, with a flat tax for the whole country. Certainly, the District could become a great model for broader national reforms. People want to know whether a flat tax is a realistic practical idea. As Dan said, the experience in other countries that have adopted flat taxes show that flat taxes—the effect of flat taxes has been very positive in the real world. And it seems to me, in today's global economy we need to get moving on tax reforms. And so, I applaud you and this committee for looking at the idea of a flat tax in the District of Columbia.

Thank you.

Senator BROWNBACK. Thank you, Mr. Edwards.

[The statement follows:]

PREPARED STATEMENT OF CHRIS EDWARDS

Mr. Chairman and members of the Committee, thank you for inviting me to testify today regarding a possible flat tax for the District of Columbia.

Last November President Bush's bipartisan Advisory Panel on Federal Tax Reform sounded the alarm regarding the need for major tax reform.[1] The Panel proposed two reform plans that would simplify the tax code, cut marginal tax rates, and reduce taxes on savings and investment. Replacing the income tax with a flat tax would create even greater simplification and economic gains than the Panel's plans. A flat tax would have one low rate and would treat savings and investment in a neutral and efficient manner.

This testimony discusses why it is crucial to move ahead with federal tax reform along the lines of a flat tax. It also discusses some aspects to consider regarding a possible flat tax for D.C.

The United States Should be a Tax Reform Leader, Not a Laggard

Despite recent tax cuts, the federal income tax system remains terribly complex and inefficient. The system is biased against savings and investment, and top income tax rates are higher today than after the last major reform in 1986.

Yet competition in the global economy has intensified and most countries have slashed their income tax rates in order to attract foreign investment and promote growth. After the 1986 tax reform, the U.S. corporate tax rate was lower than in most countries, but today the rate is one of the highest in the world. While U.S. companies face non-tax challenges such as high pension costs, it makes no sense to also burden them with an anti-competitive tax regime as they struggle to expand in domestic and foreign markets.

What tax reforms should the United States pursue? The countries of Eastern Europe have shown the way ahead with sharp cuts to individual and corporate income tax rates. These countries have shown that low-rate flat taxes are not just an economist's dream, but a practical reality that can boost growth, reduce tax avoidance, and increase fairness.

Here is a summary of some of the tax reforms abroad:

—*Hong Kong*.—Hong Kong has long had one of the world's most efficient tax systems. The corporate income tax has a low 17.5 percent rate. The individual income tax has graduated rates from 2 to 20 percent and various deductions, but individuals can instead pay a 16 percent flat tax on a broader base. Individuals are not taxed on dividends or capital gains.

[1] President's Advisory Panel on Federal Tax Reform, "Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System," November 2005, www.taxreformpanel.gov.

—*Ireland*.—Ireland has the second-highest income per capita and the lowest overall tax burden in Europe. Its economy has grown rapidly as a result of pro-market reforms including tax cuts. The corporate tax rate is just 12.5 percent.

—*Estonia*.—Prime Minister Mart Laar launched the European flat tax revolution in 1994 by instituting a 26 percent flat tax for individuals and corporations. Estonia is phasing down its rate to 20 percent. Another pro-growth change, adopted in 2000, was to exempt corporate retained earnings from tax. Estonia has become a magnet for foreign investment and has enjoyed strong economic growth.

—*Lithuania*.—In 1994 Lithuania cut its corporate tax rate to 29 percent and its top individual rate to 33 percent. In 2002 the corporate rate was cut to 15 percent. In 2005 Lithuania passed a phased-in cut to its top individual rate to 24 percent. The tax rate on dividends is 15 percent.

—*Latvia*.—In 1995 Latvia cut its top individual tax rate to 25 percent. The corporate tax rate was reduced from 35 percent in 2001 to 15 percent in 2004. Domestic dividends are exempt from tax.

—*Hungary*.—Hungary cut its corporate tax rate to 18 percent in 1995 and reduced it further to 16 percent in 2004. Hungary has a top individual income tax rate of 38 percent, but dividends are taxed at a lower rate.

—*Russia*.—In 2001 Russia replaced its individual income tax, which had rates up to 30 percent, with a 13 percent flat tax. In 2002 it cut its corporate tax rate from 35 to 24 percent. Russia's system is not a pure flat tax, as it retains some deductions and narrow provisions. Domestic dividends are taxed at just 9 percent. Russia's tax reforms have been a big success. In recent years, the nation's economy has grown strongly, tax revenues have risen, and tax evasion has fallen.

—*Serbia*.—In 2003 Serbia enacted a flat income tax with a 14 percent rate on individuals and corporations.

—*Ukraine*.—In 2004 Ukraine replaced its individual income tax, which had a top rate of 40 percent, with a 13 percent flat tax. It also cut its corporate tax rate from 30 to 25 percent.

—*Slovakia*.—Slovakia adopted a flat rate tax of 19 percent on individuals and corporations in 2004. The top tax rates had been 38 percent and 25 percent, respectively. For individuals, the flat tax has a large basic exemption and few special preferences. Dividends are exempt from tax. Slovakia is attracting large investment inflows and its economy is growing strongly.

—*Poland*.—In 2004 Poland cut its corporate tax rate from 27 to 19 percent. The top individual rate is a high 40 percent, but reforms may be on the way. One party in the new coalition government favors a low-rate flat tax, while the other favors a cut in the top rate to 32 percent.

—*Georgia*.—In 2005 Georgia adopted an individual flat tax with a 12 percent rate. The top individual rate had been 20 percent. The corporate tax rate is 20 percent.

—*Romania*.—Soon after coming into office, Romania's new president issued an edict to replace the nation's income tax with a 16 percent flat tax on individuals and corporations, effective for 2005. The top tax rates had been 40 and 25 percent, respectively.

The table below shows that the United States has much higher income tax rates than do these flat tax countries. Indeed, the United States has a higher corporate tax rate than virtually all our trading partners. The average top corporate tax rate in the European Union is 26.6 percent, which compares to the U.S. federal and average state rate of 39.5 percent.[2]

TOP STATUTORY INCOME TAX RATES, 2005

[In percent]

Country	Individual	Corporate
COUNTIRES WITH INDIVIDUAL FLAT TAXES		
Estonia	24.0	24.0
Georgia	12.0	20.0
Latvia	25.0	15.0
Lithuania	33.0	15.0
Romania	16.0	16.0

[2] Chris Edwards, "Catching Up to Global Tax Reforms," Cato Institute Tax & Budget Bulletin no. 28, November 2005.

TOP STATUTORY INCOME TAX RATES, 2005—Continued

[In percent]

Country	Individual	Corporate
Russia	13.0	24.0
Serbia	14.0	14.0
Slovakia	19.0	19.0
Ukraine	13.0	25.0
Flat tax countries	18.8	19.1
OTHER COUNTRIES AND REGIONS		
Czech Republic	32.0	26.0
Hong Kong	16.0	17.5
Hungary	38.0	16.0
Ireland	42.0	12.5
Poland	40.0	19.0
Singapore	22.0	20.0
Europe: 25 countries	40.6	26.6
United States	38.6	39.5

Source: Chris Edwards, Cato Institute, based on KPMG data and various news reports. Rates include the national and average subnational tax rate.

I suspect that countries around the world will continue to cut corporate tax rates, partly because of the large benefits that can be gained by attracting greater inflows of foreign investment. As much as $1 trillion of direct investment crosses international borders each year, and research shows that these flows are increasingly sensitive to taxes.[3] Our tax system, particularly the corporate income tax, will have an increasingly negative effect on U.S. growth unless reformed. Also note that high tax rates and excessive tax complexity create an ideal breeding ground for Enron-style tax scandals.

The solution is to sharply cut the top corporate and individual income tax rates, either within a full flat tax reform package or under more limited reforms.[4] U.S. policymakers need to wake up to the new global tax realities and put marginal tax rate cuts front and center in federal policy discussions. Replacing the high-rate income tax with a flat tax would be a great way to accomplish that.

A Flat Tax for D.C?

The first thing to note about taxation in D.C. is the high marginal tax rates on individuals and businesses. The top D.C. individual tax rate is 9.0 percent, which compares to a 50-state average of 5.5 percent.[5] The top D.C. corporate rate is 10.0 percent, which compares to a 50-state average of 6.9 percent.

Thus, regardless of possible federal tax changes in D.C., it would make sense for the city to reduce its high local tax rates to at least national average levels. I have argued that states should kill their corporate income taxes altogether, as these taxes have very high compliance costs compared to the little revenue collected.[6] If a federal tax reform such as a flat tax were introduced in D.C., extra local revenue that is generated from higher economic growth should be used to cut high local income tax rates.

A D.C. flat tax that is voluntary is an interesting idea for policymakers to consider. One model for a flat tax is the Hong Kong tax system. That city's individual income tax has a graduated rate structure, but it provides taxpayers with an alternative of a 16 percent flat tax applied to a broader tax base.

A voluntary flat tax would presumably result in a (static) federal revenue loss because no taxpayers would pay more than under the current system, while some would pay less. Because that may create a political hurdle, I'd suggest that the revenue loss be at least partly offset with cuts to federal spending in the District. Cuts could be made both to D.C. appropriations as well as spending under regular federal programs. For example, economic development funding could be cut, including pro-

[3] Chris Edwards and Veronique de Rugy, "International Tax Competition: A 21st-Century Restraint on Government," Cato Institute Policy Analysis no. 431, April 12, 2002.

[4] For a discussion of federal tax reform options, see Chris Edwards, "Options for Tax Reform," Cato Institute Policy Analysis no. 536, February 24, 2005.

[5] Chris Edwards, "State Revenue Boom Paves Way for Tax Cuts," Cato Institute Tax & Budget Bulletin no. 30, January 2006.

[6] Chris Edwards, "State Corporate Income Taxes Should Be Repealed," Cato Institute Tax & Budget Bulletin no. 19, April 2004.

grams such as Community Development Block Grants. Such spending is dubious to begin with, but certainly would not be needed with all the new investment pouring into the District to take advantage of the low federal tax rates.

Another aspect to consider is that if a D.C. flat tax created a federal revenue loss, neighboring states might complain that D.C. residents were getting an unfair benefit. Again, the solution would be to cut federal spending in D.C. We could have a revenue neutral policy change that resulted from less federal taxes and less federal spending in the city, which would be combined with a more vibrant private sector economy.

There is a parallel idea being proposed for federal highway spending. Bills have been introduced in Congress that would allow a state to opt-out of the federal highway system by ending both the federal gas tax and federal highway spending in a state. Thus, a state would pay less to the federal government but also get less back, in a roughly revenue neutral fashion.

A flat tax for the District would (or could) include reforms to both individual and corporate taxes. Note that, in general, corporate tax cuts have larger beneficial effects on the economy than individual tax cuts. Last year the Joint Committee on Taxation modeled the effects of equal-sized hypothetical cuts to the federal corporate and individual income taxes.[7] They found that in the long run a corporate rate cut caused a much larger increase in gross domestic product than an individual tax cut. The upshot for D.C. is that cutting the corporate tax rate (either the federal rate in the city or the local rate) would probably give the biggest bang for the buck to boost the city's economy.

Conclusion

The goal of federal policymakers should be to replace the current income tax with a low-rate consumption-based system—such as the flat tax—for the whole country. A flat tax for D.C. is an interesting idea that could be the model for broader national reforms.

Many people are interested in the flat tax, but want to know whether it would work as well as proponents expect it to. Certainly, the experience in countries that have adopted flat taxes has been very positive. In today's competitive global economy, we need to get moving on major tax reforms, and so I applaud the committee for exploring these issues.

Thank you for holding these important hearings. I look forward to working with the Committee on its flat tax agenda.

Senator BROWNBACK. Mr. Entin, glad to have you here.

STATEMENT OF STEPHEN J. ENTIN, PRESIDENT AND EXECUTIVE DIRECTOR, INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

Mr. ENTIN. Thank you, Mr. Chairman. Thank you for the opportunity to testify. I commend you and the subcommittee for wanting to demonstrate the gains that real tax reform could bring to workers and savers at all income levels.

If I have any cautionary points to make, they stem from my concern that you haven't gone far enough. So, I am friend of the effort.

Fundamental tax reform is about creating a tax system that is simpler and more conducive to economic growth than the current income tax. Simplicity alone is not enough. For example, "Line 1, put down your income; Line 2, send it in," is as simple a tax system as you can get, but it is not conducive to growth. Economic growth means defining income correctly to get the tax base right, and taxing it in a uniform, nondistorting manner.

The key question is, What is the tax base? Today's income tax falls more heavily on income used for saving and investment than consumption, and imposes further burdens with an add-on corporate tax and transfer—that is, estate and gift taxes. Long depre-

[7] Joint Committee on Taxation, "Macroeconomic Analysis of Various Proposals to Provide $500 Billion in Tax Relief," JCX–04–05, March 1, 2005.

ciation periods further discourage investment. These taxes reduce productivity, wages, employment, and incomes across the board.

Neutral taxes, of which the flat tax is one, by contrast, treat all economic activity alike. They do not discourage those who produce the most with steeply graduated tax rates, and they are not biased against saving and investment in favor of consumption. Neutral tax systems, sometimes called "consumption-based taxes," include the saving-deferred tax, the national retail sales tax, the value-added tax, returns-exempt flat tax, or some combination.

Neutral taxes give saving the sort of treatment we give to limited amounts of pensions and IRAs. They don't double tax the corporation or the estate. They allow expensing, rather than depreciation. I go into these reasons in the addendum to the testimony, but I won't dwell on that here.

Just let me say that if the United States replaced its personal and corporate income taxes with a saving/consumption-neutral tax and eliminated the estate and gift taxes, capital investment, productivity, wages, and employment would increase, national output and national income would rise by 10 percent within about 7 to 10 years. A middle-income family of four earning about $50,000 would see roughly $5,000 in additional annual income. That's before tax, or about $3,500 after tax. Allowing for income growth over time, that 10 percent differential would be enough to allow the family to live in a $350,000 house instead of a $200,000 house, or to pay to send a child to a good college, or to retire with greater security. These are real benefits that we are simply throwing away by having a tax system that depresses saving and investment.

Now, we hear a lot about the "flat tax." What do we mean by the term? Several Eastern European countries, as Dan has described have adopted so-called "flat" income taxes. They apply a single tax rate—hence, "flat tax"—to personal income, corporate income, and payroll or sales. These taxes are flat, only in the sense that they have one tax rate imposed several times. Saving is taxed twice, compared to consumption, and corporate income is taxed a third time. These systems are not fundamental tax reform. They improve simplicity and reduce compliance costs, but do not maximize growth and income. Now, I will say they are much better than the systems they replace, but they don't go far enough.

By contrast, the Hall-Rabushka and Armey-Shelby flat taxes impose a single tax rate on nearly neutral consumed income base. They eliminate most tax biases against saving and investment in the corporate form. They tax capital income at the source, with many deductions eliminated for simplicity. I would say that some deductions needed to measure income accurately are eliminated, which can place some income on the wrong person's tax form, as by ignoring transfers, or may misstate income by ignoring certain business and education costs, including payments for State and local government services and education.

The other neutral taxes similarly have flat rates in expensing and eliminate the antisaving biases. They differ in that they also exempt tuition and training, deduct or exclude State and local taxes or outlays for education, transfers to the poor, and services to business. And they correctly handle transfers such as charitable contributions, gifts, or alimony as income of the recipient.

That aside, the various consumed income or HR-style, Hall-Rabushka style, neutral taxes combine simplification with big spurs to economic growth. They are fundamental tax reforms worthy of the name. The economic benefits are well known, and it is long past time that one of them was adopted.

The question here today is, what benefits might be had from enacting a voluntary saving, consumption-neutral tax—specifically, a variation of Hall-Rabushka—for the District of Columbia? Individuals could volunteer to give up certain deductions in exchange for lower marginal tax rates and less onerous tax treatment of saving and investment. Such a demonstration would be feasible if some modifications are made to allow the tax to apply only to residents of the District or to any State or region, rather than to the Nation as a whole.

These tax reforms, if enacted for the District, would lower the cost of capital for firms investing here. It would reduce, in some manner, the tax imposed on savers living in, or lending to, the District. Investment and employment would increase, and some of the increase would be investment attracted from over the borders from Maryland and Virginia, some would represent a rise in national economic output.

The District has few manufacturing businesses, perhaps due to its limited geographical area, and it is likely to remain a place where human capital and labor-intensive service jobs dominate. Much of the investment might take the form of residential rental units. Some savers would find the District more attractive than their current States of residents for tax purposes, and might move here. Property values would be bid up. Additional residential construction should lower rents regionally, although the impact on specific neighborhoods within and about the District would vary. District income and property tax revenues would rise.

Be warned, in scoring the budget cost of a flat tax proposal, the Treasury and the Joint Committee on Taxation of the Congress will not assume any gains in national economic output, because they are wedded to a static scoring method. They will not show gains in wages for District residents, which will distort the apparent income distribution of the tax changes.

The proposal would make the tax voluntary. This is possible, to some degree, but there would have to be coordination between borrowers and lenders so that they were treating the same asset at—the same way on both ends. You would perhaps have to look at what would happen to fringe benefits if employers, versus employees, opted for different treatments.

There would be some regional problems in implementation. You would have to very clearly define the payments to the savers that would be eligible for the alternative treatments. You would have to decide what would happen to that tax treatment if they moved out of the District. You would have to look at what would happen if businesses were lending nationally, not just within the District, and perhaps imposed some of these same sorts of rules governing international allocation of interest and income between the District and the rest of the country, as we now impose between countries—companies operating here and operating globally. However, these

things could be worked out. I'm not saying they would be easy, but they could be done.

In conclusion, the benefits of shifting to a saving/consumption-neutral tax system would be large, and would be distributed across most of the population. It's long past time for adopting such a system. I prefer to see it be done quickly and nationwide, but that may not be possible.

I would hope that, at the very least, we can extend the 2003 tax reductions on capital gains, dividends, marginal tax rates, and on the elimination of the estate tax. These are all steps toward fundamental tax reform. They go part of the way there, and I describe the benefits of that in the addendum to the report.

Thank you very much.

[The statement follows:]

PREPARED STATEMENT OF STEPHEN J. ENTIN

Mr. Chairman and Members of the Subcommittee: Thank you for the opportunity to testify on the economic advantages of fundamental tax reform. The Subcommittee is to be commended for exploring the gains that reform could bring to workers and savers at all income levels, and in all corners of the nation.

Fundamental tax reform is about creating a tax system that is simpler and more conducive to economic growth than the current income tax. Simplicity alone is not enough. For example—"Line one: Put down your income. Line two: Send it in."—is as simple a system as one can get, but it is not conducive to economic growth. Economic growth means defining income correctly to get the tax base right, and taxing it in a uniform, non-distorting manner.

What is the tax base?

The broad-based income tax. The comprehensive or broad-based income tax in use today taxes most income as it is received, including income used for saving, and taxes the returns on saving as soon as they accrue (except for capital gains, which can be deferred until realized). Such taxes fall more heavily on income used for saving than for consumption.[1] The tax bias against saving is made worse by imposing an add-on corporate tax and transfer (estate and gift) taxes. Long write-off periods for depreciable assets further discourage investment.[2] These taxes impose high economic costs, including reduced productivity, wages, and incomes across the board.

Neutral taxes. Neutral taxes are those that treat all economic activity alike. In particular, they do not discourage those who produce the most with steeply graduated tax rates, and they are not biased against saving and investment in favor of consumption. Neutral tax systems (sometime called consumption-based taxes) include the saving-deferred tax[3], the national retail sales tax, the value added tax

[1] Income is ordinarily taxed when earned. If the income is used for consumption, there is generally no further federal tax (except for a few selective excises). One can buy a loaf of bread and eat it, or buy a television and watch a stream of programming, and there is no further federal tax. If it is used for saving, however, the returns on the saving (the streams of interest, dividends, capital gains, or profits of non-corporate businesses) are taxed. This is the basic income tax bias against saving. If used to buy corporate stock, the returns are also subject to the corporate tax before being paid as a dividend or reinvested to raise the value of the company (leading to a capital gain). This is a third layer of tax on saving. The estate tax is a fourth layer of tax on income that is saved. Even if the inherited saving was done in a tax deferred pension (offsetting the basic bias), it will be subject to the heirs' income tax, so the transfer taxes are always an extra layer of tax on saving.

[2] Depreciation forces businesses to delay claiming the costs of their investments in depreciable assets. The long write-off periods reduce the value of the capital consumption allowances by ignoring inflation and the time value of money. The allowances fall short of the real cost of the assets, overstating real profits and raising effective tax rates. Capital formation is discouraged, and productivity and wages are reduced. The correct tax treatment would be "expensing", that is, writing off the cost of investment assets immediately, in the year they are made. Expensing would correctly account for the real cost of investment, reducing the excess tax burden on capital and expanding investment and wages.

[3] A tax on income less net saving, in which all saving is tax deferred in the manner that current law allows for limited amounts of saving in an ordinary IRA, 401(k), or pension. This type of tax is also called an inflow-outflow tax, a consumed income tax, an individual cash flow tax, or an expenditure tax.

(VAT)[4], the returns-exempt Flat Tax[5], or some combination. To put saving and consumption on an equal footing, a tax system must impose the same tax, in present value, on income used for immediate consumption and on income saved for future consumption. To do so, neutral taxes either defer taxes on income saved (as with a pension or regular IRA) and tax the subsequent withdrawals of principal and earnings, or tax the income up front but eliminate taxes on the returns (as with a Roth IRA). Neutral systems do not have add-on layers of tax at the corporate level, either taxing the returns on corporate assets at the business level or the shareholder level, but not both. There is no estate or gift tax. Capital outlays are expensed immediately, rather than depreciated over time.

Benefits of neutral taxes

A saving-consumption neutral tax with a flat rate would serve every type of economic actor better than the current income tax system, which includes the graduated comprehensive personal income tax, the corporate income tax, and the estate and gift taxes. If the United States were to replace its personal and corporate income taxes with a savings-consumption neutral tax, and eliminate the estate and gift taxes, the country would experience a sharp reduction in the service price of capital, and a major increase in capital investment. Productivity, wages, and employment would increase. If the basic tax rate were kept low, there would be a further labor force response. All told, there would be something over a ten percent increase in national output and national income within about seven to ten years.

For a middle income family of four earning about $50,000, that would mean a roughly $5,000 increase in annual income, before tax (and about $3,500 after tax). Allowing for a percent a year in real income growth over a working lifetime due to technological change, that initial 10 income percent differential would be enough to allow the family to live in a $350,000 house instead of a $200,000 house, or to pay to send a child to a good college, or to retire with greater security. With a "static" revenue neutral tax restructuring, there would be a significant positive revenue feedback for federal, state, and local tax authorities, reducing budget pressures. Alternatively, the revenue feedback could be used to further lower tax rates on labor and capital income. These are non-negligible real benefits that we are simply throwing away by having a tax system that is unnecessarily harsh on saving and investment.

What is meant by a "flat tax?"

The European "flat taxes" on an income base. Several Eastern European countries have adopted so-called "flat" income taxes. They apply a single tax rate (hence "flat" tax) to personal income, corporate income, and payroll or sales. These taxes are non-neutral, and are "flat" only in the sense that they have one tax rate, imposed several times. Saving is taxed twice compared to consumption, and corporate income is taxed a third time. These systems are partial, but not fundamental, tax reform. They improve simplicity and reduce compliance costs, but do not maximize growth and income.

The Hall-Rabushka-Armey-Shelby Flat Tax on a consumed-income base. The Hall-Rabushka and Armey-Shelby "Flat Taxes" impose a single tax rate on a nearly neutral consumed-income base. They eliminate most tax biases against saving and investment and the corporate form. They are largely saving-consumption neutral because capital investment is expensed and corporate income is taxed only once at the business level and not again at the shareholder level. They tax capital income at the source, with many deductions eliminated for simplicity. However, some deductions needed to measure income accurately are eliminated for simplicity. Some call this part of the tax's "flatness", but this feature can place some income on the wrong person's tax form, as by ignoring transfers, or may misstate income by ignoring certain business and education costs, including payments for state and local government services and education.

Other neutral consumed-income or cash-flow taxes. A consumed-income or consumption-based tax retains only those deductions needed to define income correctly (as revenue less the cost of earning revenue), and allocates the income for tax purposes to those who get to spend it by means of appropriate treatment of transfer payments. These systems include the consumed-income tax (revenue less saving =

[4] Value added tax, including European style credit invoice method VATs, goods and services taxes or GSTs (as in Canada and Australia), or subtraction method VATs (also called business transfer taxes in the United States, such as is proposed in the USA Tax).

[5] A returns exempt tax does not allow a deduction for or deferral of current saving, which must be done on an after-tax basis, but it does not subsequently tax the returns on that after-tax saving. It is the method used for Roth IRAs, and is how individual savers are treated in the Hall-Rabushka or Armey-Shelby Flat Tax.

consumption spending), national retail sales tax (consumption spending), or VAT (consumption spending). All include expensing of investment outlays; exempt tuition and training; deduct (or exclude) state and local taxes (or outlays) for education, transfers to the poor, and services to businesses; and correctly handle transfers such as charitable contributions, gifts, or alimony as income of the recipient.

The various consumed-income or H-R style neutral taxes combine simplification with the biggest potential for income growth. These are fundamental tax reforms worthy of the name. The economic benefits are well-known, and it is long past time that one of them was adopted. In recent years, each time we have moved in the direction of a neutral, pro-growth tax system, the economy has responded with more jobs and rising output. The tax reductions of 2001, as amended in 2003, with lower marginal tax rates, reduced double taxation of corporate income via the 15 percent rate caps on dividends and capital gains, and repeal of the estate and gift taxes, are steps in the right direction. We could achieve fundamental reform nationwide in stages, making these rate reductions permanent, enlarging the amounts of saving eligible for neutral treatment in IRAs and pensions, and shortening asset lives. Later, we could more completely integrate the individual and corporate taxes.

A Flat Tax for the District of Columbia?

The question here today is what benefits might be had from enacting a voluntary saving-consumption neutral tax, specifically, a variant of the Hall-Rabushka "Flat Tax", for the District of Columbia, as an example for the nation. Individuals could volunteer to give up certain deductions in exchange for lower marginal tax rates and less onerous tax treatment of saving and investment. Such a demonstration would be feasible if some modifications are made to allow the tax to apply only to residents of the District (or to any state or region), rather than to the nation as a whole.

Benefits for the District and the cost to the Treasury. A Flat Tax, or some variant, if enacted for the District, would lower the cost of capital for firms investing here. It would reduce, in some manner, the tax imposed on savers living in or lending to the District. Investment and employment would increase. Some of the increase would be investment attracted from over the borders from Maryland and Virginia. Some would represent a rise in national economic activity.

The District has relatively few large manufacturing businesses, in part due to its limited geographical area. It is likely to remain a place where human capital and labor intensive service jobs dominate (law firms, hospitals, schools, restaurants). Much of the investment might take the form of residential rental units. Some savers would find the District more attractive than their current states of residence for tax purposes, and might move here. Property values would be bid up. Additional residential construction should lower rents regionally, although the impact on specific neighborhoods within and without the District could vary. District income tax and property tax revenues would rise.

In scoring the budget cost of a Flat Tax proposal, the Treasury and the Joint Tax Committee of the Congress will not assume any gains in national economic output, because they are wedded to a static scoring method. The revenue estimators will not show the gains in wages for District residents, which will distort the distribution of the tax reductions across income classes. If they are being truly static, they would calculate the revenue change by looking only at the proposal's effect on current residents, without assuming many more people will move into the District to take advantage of the tax change. If the estimators wish to be antagonistic to the idea, they will omit the economic gains but assume a large influx of people into the District in search of lower tax rates on their capital and salary income.

A voluntary application. The proposal would make the Flat Tax voluntary. That is possible to some degree, but there would have to be some areas of coordination between employers and employees, and between borrowers and lenders.

For example, under the Flat Tax (and VAT), borrowers are not allowed to deduct interest, but lenders do not have to pay tax on interest received. Mortgages would carry the current after-tax interest rate, instead of the higher pre-tax rate we see today, and borrowers and lenders would be in the same net position, after-tax, as they are now. But if a homeowner or business borrower opted out of the Flat Tax, but its lender opted in, the interest income might escape tax entirely. There would have to be a requirement for each loan to be treated alike by the borrower and the lender. For example, financial firms might be allowed to offer homeowners either a taxable or a non-taxable mortgage, with both sides treating the interest on that particular loan alike.

Also under the Flat Tax, businesses are not allowed to deduct fringe benefits, including health insurance premiums. In return, these are not taxable on the workers' tax forms, and they get a lower tax rate on their cash wages. If workers participate, but businesses opt not to participate, some fringe benefits might continue to escape

tax entirely. Workers might get reduced tax rates without the "base broadening" that is meant to offset the revenue loss and make the tax system more neutral and efficient. If this aspect of the Flat Tax is retained, it would affect the revenue estimate. Workers and their bosses might have to opt in or opt out jointly to make the system work smoothly.

Regional considerations in designing the proposal

Even with adjustments to the voluntary feature of the proposal, imposing a Flat Tax on a region within the country raises a number of administrative, enforcement, and compliance issues.

All the major neutral tax systems are internally consistent applied nationwide. All specify consistent choices and definitions for income that crosses the national border. Similar care would be needed to preserve consistency if such taxes were to be implemented on a regional or state basis.

The Hall Rabushka and other saving-consumption "neutral" taxes are really quite similar, falling on roughly the same amount of consumed income each year, with the main difference among them being the point of collection. Because of this difference, two of the systems would not be suitable for use in a sub-region of the country, such as the District of Columbia. The retail sales tax could be avoided by driving to Maryland or Virginia to shop. A "destination" type VAT (imposed on imports, rebated on exports) would require customs sheds at the bridges and border-crossing roads. An "origin-type" VAT (imposed on wages and capital income of residents) could be adapted to regional use. So could the Hall-Rabushka "Flat Tax" or the consumed income tax, with appropriate modifications.

Residency requirements. It would be necessary to make rules relating to part time residents. The federal tax system would need to include the same sort of rules as states impose when people move in or out of their jurisdiction during the year. Presumably, the part-time District residents would be under one system for part of the year, and another for the remainder.

The IRS would have to determine the validity of claims to residency status. If state practice is a guide, there would need to be requirements for people to be physically present for a number of days to qualify for the favored tax status. As a Federal tax example, under changes enacted in 2004, the IRS is currently adding a modest days-per-year residency requirement to narrow eligibility for the federal income tax relief granted to residents of the U.S. Virgin Islands under section 936. Some sort of residency requirement would be needed for the District tax.

Treatment of capital income. Saving-consumption neutral taxes either defer tax on income that is put into saving (as in a regular IRA or pension) and tax withdrawals from saving, or they tax income up front and exempt the returns (interest, dividends, or capital gains, as with a Roth IRA or municipal bond). Businesses expense outlays instead of depreciating them. If these features were retained in the District tax, then rules would be needed to define their application to individuals and businesses.

Individuals under a regional tax. Individuals willing to give up some of their existing deductions could be offered a lower tax rate. High income, high saving individuals who have otherwise maxed out on their pension IRA and 401(k) contributions would find the District an attractive place to live, at least for tax purposes, because they would receive some form of pension treatment on more of their saving. The legislation setting up the District tax would have to define that treatment clearly.

For example, under the returns-exempt method of the Hall-Rabushka tax, what would happen if people have lived and saved in the District, and later move out? Would they lose the exemption on the returns on the saving they did while living in the District? Some people would not save as much as the Flat Tax would ordinarily encourage them to do if this string were attached.

If, alternatively, the deferral of saving method applied, then people would get universal IRA treatment of saving contributions for years in which they live in the District, but not for years they live outside. If they move out of the District, would they have to pay tax immediately on such accounts, or only when they withdraw the money? Would the inside build-up continue to be tax-deferred until withdrawal, or become taxable annually? Saving would be higher if the accounts were to retain their saving-deferred treatment until withdrawal. Either approach is administrable, but the legislation would have to set the rule.

Businesses under a regional tax. A small business owner living and working in the District would presumably get to expense his District business outlays, and would pay tax on all returns. For a corporate or non-corporate business that operates in many states and the District, presumably only its investments placed in service in the District would be expensed.

In the Hall-Rabushka Flat Tax, corporate income is taxed at the business level, and is not taxed again at the shareholders' level. The legislation would have to specify whether the District income of corporations paid as a dividend is to be exempt only for District residents or for shareholders nationwide. To realize the full economic effect, it should be nationwide. To determine how much of a capital gain stemming from reinvested after-tax District business income should be tax free, a "deemed dividend" (a notice allowing shareholders to raise the tax basis of their shares by the reinvested District income) could be adopted. Again, the legislation would have to specify if that were to apply only to shareholders who live in the District, or to all shareholders.

Under the Hall-Rabushka tax plan, financial transactions are not taxed. Interest is non-deductible by the borrower, and not taxable to the lender.[6] If the tax system is only applied in the District, there would have to be rules governing the treatment of interest paid and received by a business with multi-state operations. Presumably, a multi-state business could deduct interest on loans taken to invest in Kansas but not on loans taken to invest in the District. Presumably, interest earned by a District-based lender on loans made to out-of-District borrowers would be taxable. Money is fungible. We have international interest allocation rules now to deal with firms that borrow and invest globally. Similar rules would be needed within the country to handle the different tax system for the District.

In a consumed-income tax, there is no corporate tax. Instead, corporate income is taxed when shareholders receive dividends or sell assets without reinvesting. If this method were chosen, each company would have to break its income into two parts, that which is District income, free of the federal corporate income tax, and that which is non-District income, taxable under the federal corporate tax. Dividends paid would then be taxable to the shareholders (wherever they reside). Noncorporate business income would appear on the owners' tax forms. Interest payments would be deductible, and interest received would be taxable, as under current law, for small business owners.

Conclusion

The benefits of shifting to a saving-consumption neutral tax system would be large and would be distributed across most of the population. It is long past the time for adopting such a system.

The country could move to such a system on a nationwide basis, step by step. Alternatively, it could proceed region by region. The latter is doable, but more difficult. Having one federal tax system for most of the country and another federal tax system for a single state or region would potentially create administrative and enforcement issues for the government and compliance problems for individual and business taxpayers that would have to be carefully addressed in writing the legislation and the regulations.

Ideally, Congress would work toward a reformed tax for the whole country step by step as budget conditions allow. If a region by region approach is adopted, it might be administratively easier to use the saving-deferred method rather than the returns-exempt method of neutral taxation. If the Hall-Rabushka approach is adopted, it would be best to modify it so as not to eliminate deductions for charitable contributions and state and local taxes.

APPENDIX—ECONOMIC BENEFITS OF EXTENDING THE FIFTEEN PERCENT TAX RATE ON DIVIDENDS AND CAPITAL GAINS AND THE OTHER PRO-GROWTH ELEMENTS OF THE 2001 AND 2003 TAX ACTS, AND OF ENACTING FURTHER REFORMS

Several provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001, as amended by the Jobs and Growth Tax Relief Reconciliation Act of 2003, helped to end the recession by turning around a severe slump in investment. Three key provisions either have expired, or soon will expire, if not extended by the Congress. The 15 percent top tax rates on dividends and capital gains, enacted in 2003, will expire at the end of 2008. The marginal income tax rate cuts enacted in 2001, and accelerated to full effect in 2003, will expire at the end of 2010. The 50 percent expensing provision in the 2003 Act was billed as a temporary jump start for investment and the recovery, and was allowed to expire at the end of 2004.

The expected future tax treatment of saving and investment affects saving and investment being done today. Allowing the remaining investment-related provisions

---

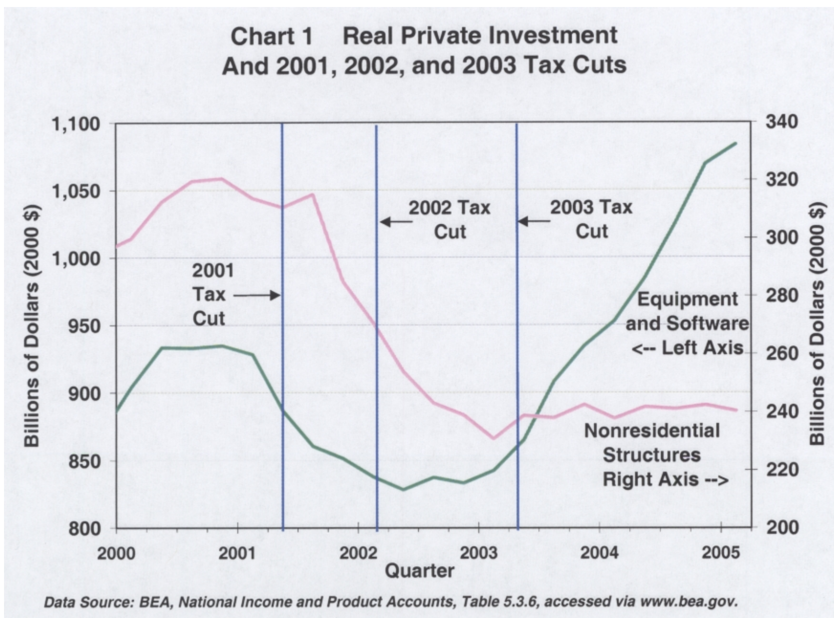
[6] Under Hall-Rabushka, special rules were suggested for taxing financial firms whose income is earned from the spread between interest earned and interest paid. Such rules appear to be difficult to design and implement. Consequently, under the Armey Flat Tax, banks and other financial institutions would be taxed as under current law, but with expensing.

to expire would jeopardize the economic recovery. Extending them now, rather than waiting until the last minute, would reduce uncertainty as to whether the more favorable tax treatment will be available for investments whose lives extend beyond the sunset dates of the tax provisions. Immediate extension would boost investment spending, employment, and wages starting now, not three to five years down the road.

All of these provisions are consistent with proposals for a fundamental reform of the tax system. Full reform would go even further in reducing tax biases against saving and investment, and the economic gains from a fundamental reform would be correspondingly larger.

Recent swings in the economy have mirrored swings in investment

The main cause of the 2001 recession was a sharp drop in investment. The decline in spending on equipment and software, and in non-residential structures, is shown in Chart 1. The chart also shows the response of investment to subsequent tax changes.



The 2001 Tax Act cut passed the Congress on May 26, 2001, but investment spending continued to slip for the rest of the year. That tax reduction did very little to encourage additional investment spending in the short run, giving out money mainly for social policies that are not related to economic growth. The bill's marginal tax rate reductions on small business owners, corporate shareholders, and other savers, which would have reduced the service price of capital and encouraged investment, were largely deferred until later years, with only half a percentage point effective in 2001. There was nothing else in the bill that directly lowered the cost of business investment.

The early stages of the economic recovery in 2002 were weak because investment remained weak. The Jobs Creation and Worker Assistance Act of 2002 was signed into law on March 9, 2002. It contained a special 30 percent "bonus expensing" provision for investment in equipment and software (but not for most structures). Also, the second half-point step in the phased income tax rate reduction became effective in 2002. Investment in equipment and software (but not structures) began to recover, modestly, over the next four quarters.

The 2003 Tax Act was signed into law on May 28, 2003. It upped the special expensing provision to 50 percent, directly cutting the cost of equipment and software (but not most structures) for corporate and non-corporate businesses. More importantly, it also brought forward to 2003 the remaining 2 to 3.6 percentage points marginal income tax rate reductions on small business owners, shareholders, and

savers scheduled for 2004 and 2006. Most importantly, for taxpayers in the top four brackets, it cut the top tax rates on dividends and capital gains from 20 percent to 15 percent through 2008. For taxpayers in the 10 percent and 15 percent brackets, the rates were set at 5 percent through 2007, and zero in 2008.

Investment in equipment and software shot up almost at once. Investment in nonresidential structures, which was helped by the capital gains, dividend, and marginal tax rate cuts, but got no direct depreciation relief, abruptly stopped its decline and rose by a slight amount. Investment and growth remained strong throughout 2004. Employment and wage growth advanced. The expensing provision expired at the end of 2004. Investment growth seems to have slowed a bit since.

The tax cuts lowered the service price of capital. Failure to extend them would raise the service price and reduce GDP

The size of the capital stock and the level of investment depend on the service price of capital. The service price is the rate of return that an investment must earn to pay the taxes owed, cover its cost (depreciation), and yield a normal after-tax return to its owner. A tax increase on capital income raises the service price, and renders impractical any investment projects that cannot meet the higher service price. A tax reduction on capital income lowers the service price, and makes additional investment projects possible.

Chart 2 and Table 1 show the service prices of various types of capital (equipment and software, structures, inventory, land) in the corporate and non-corporate sectors under 2004 law, with all three investment-related tax provisions in place. They also show the higher service prices that would result from their expirations, first of the expensing provision, then the 15 percent tax cap (corporate sector only), and then the marginal rate reductions. The numbers are for the private business sector, which is about 80 percent of GDP. The corporate sector is about 56 percent, and the non-corporate private sector about 24 percent of GDP.

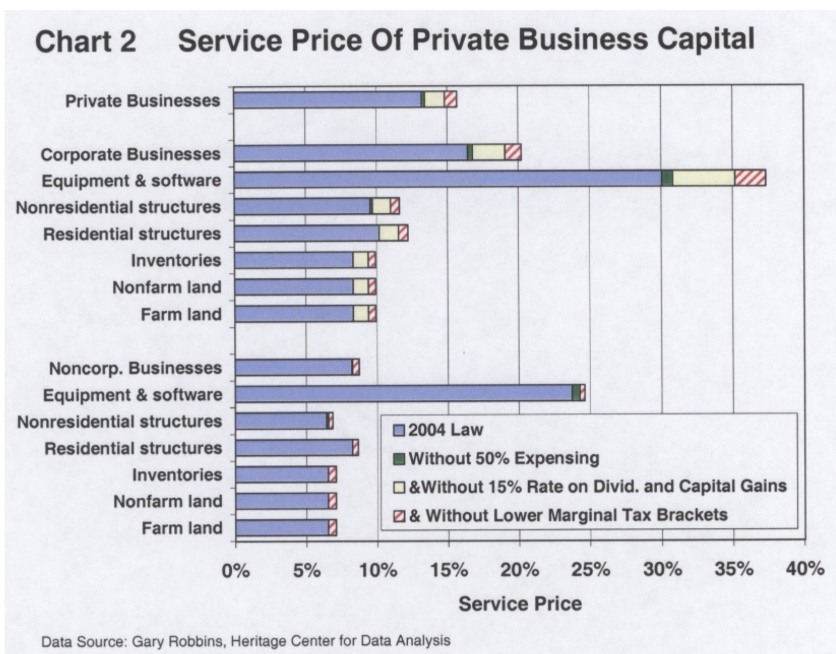


TABLE 1.—SERVICE PRICE OF PRIVATE BUSINESS CAPITAL

	2004 law	Without 50 percent expensing	Without 15 percent rate on dividends and capital gains	Without lower marginal tax brackets
Private Businesses	0.132	0.134	0.148	0.157
Corporate Businesses	.165	.168	.191	.202
Equipment and software	.301	.308	.352	.373
Nonresidential structures	.096	.097	.110	.116
Residential structures	.102	.102	.115	.122
Inventories	.083	.083	.094	.099
Nonfarm land	.083	.083	.094	.099
Farm land	.083	.083	.094	.099
Noncorporate Businesses	.082	.083		.087
Equipment and structures	.237	.243		.246
Nonresidential structures	.064	.066		.069
Residential structures	.082	.082		.086
Inventories	.065	.065		.071
Nonfarm land	.065	.065		.071
Farm land	.065	.065		.071

Date Source: Gary Robbins, Heritage Center for Data Analysis.

The tax changes of 2003 boosted investment and GDP by lowering the service prices of various types of capital to the 2004 levels shown. For the whole private sector, the reduction was 2.5 percentage points, from 15.7 percent to 13.2 percent. The biggest reduction was in the corporate sector (a drop of 3.7 points, from 20.2 percent to 16.5 percent), where the largest cut was on equipment and software (7.2 points, from 37.3 percent to 30.1 percent). All three of the investment-related tax provisions, including the 15 percent tax rate on dividends, applied to the corporate sector. The non-corporate sector benefitted mainly from the individual marginal income tax rate reductions and the expensing provision. The service price in the non-corporate sector, which fell from 8.7 percent to 8.2 percent, is far lower than in the double-taxed corporate sector.

The biggest reduction in the corporate service price on equipment and software (over 4 points) was due to the 15 percent rate cap on dividends and capital gains, which reduced the double taxation of corporate income. Next in size was the marginal tax rate reductions on shareholders (about 2 points), then the expensing provision (under 1 point). In the non-corporate sector, on all assets together, the marginal tax rate reductions had the bigger impact, with expensing larger for equipment and software.

Allowing the expensing provision to expire eliminated about 8 percent of the cut in the service price available in 2004. Allowing the 15 percent rate cap on dividends and capital gains to lapse would eliminate about 56 percent of the cut in the service price. Allowing the marginal tax rate reductions to expire would end the remaining 36 percent.

Each percentage point reduction in the service price of capital increases the capital stock over time by about 1.5 percent. The resulting increase in the productivity of labor increases the demand for labor, and raises the total wage bill by a roughly similar percent. Private sector GDP rises by about 1.5 percent, with about two-thirds going to labor income and about one-third going to capital income, pre-tax. Various layers of government take a bit over 30 percent of the increase in income as taxes, a revenue gain of about $40 billion to $50 billion a year. Increases in the service price have the opposite effect on incomes and tax revenues. Failure to account for the changes in GDP and incomes, particularly labor incomes, seriously distorts the estimated revenue consequence of changes in taxation of capital.

Every tax bill relating to capital income and cost recovery that Congress considers should be examined for its effect on the service price of capital. The Joint Committee on Taxation, in conjunction with the Congressional Budget Office, should develop or borrow the software to conduct that calculation, and report the result to the Finance and Ways and Means Committees along with the (static) revenue estimate. If the bill increases the service price, it will reduce investment and GDP, which will reduce or eliminate the expected revenue from the provision. If the bill lowers the service price, it will raise GDP, which will provide some revenue reflow. If you are comparing two tax provisions, and one raises the service price more than the other relative to the amount of revenue expected to be raised, then that bill will do more economic damage, per dollar of revenue raised, than the other.

Current tax system is biased against saving and investment

The 15 percent top tax rate on capital gains and dividends is a step toward fundamental tax reform. It may be thought of as mitigating the double taxation of corporate income. Alternatively, it may be viewed as offsetting some of the basic income tax bias against saving, in effect extending to more saving about half of the tax relief given under Roth IRAs.

Federal and state tax systems hit income that is saved harder than income used for consumption. At the federal level there are at least four layers of possible tax on income that is saved.

(1) Income is taxed when first earned (the initial layer of tax). If one uses the after-tax income to buy food, clothing, or a television, one can generally eat, stay warm, and enjoy the entertainment with no additional federal tax (except for a few federal excise taxes).

(2) But if one buys a bond or stock or invests in a small business with that after-tax income there is another layer of personal income tax on the stream of interest, dividends, profits or capital gains received on the saving (which is a tax on the "enjoyment" that one "buys" when one saves). The added layer of tax on these purchased income streams is the basic income tax bias against saving.

(3) If the saving is in corporate stock, there is also the corporate tax to be paid before any distribution to the shareholder, or any reinvestment of retained after-tax earnings to increase the value of the business. (Whether the after-tax corporate income is paid as a dividend, or reinvested to raise the value of the business, which creates a capital gain, corporate income is taxed twice—the double taxation of corporate income.)

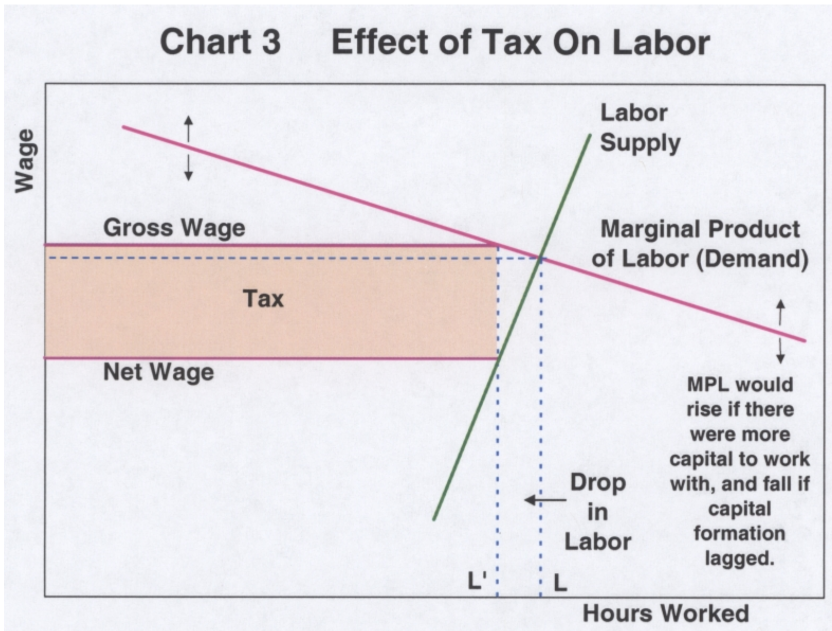
(4) If a modest amount is left at death (beyond an exempt amount that is barely enough to keep a couple in an assisted living facility for a decade), it is taxed again by the estate and gift tax.

Eliminating the estate and gift tax and the corporate tax would remove two layers of bias. Granting all saving the treatment given to pensions or IRAs, either by deferring tax on saving until the money is withdrawn for consumption (as in a regular IRA), or by taxing income before it is saved and not taxing the returns (as in a Roth IRA), would remove the basic bias. Saving-deferred taxes, the Flat Tax, VATs, and retail sales taxes are examples of saving-consumption neutral taxes.

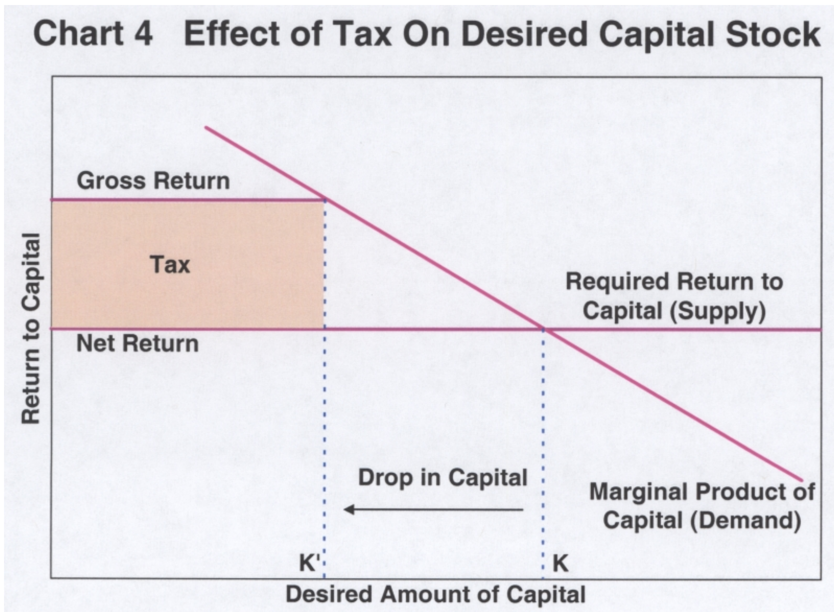
The tax on capital gains is a double tax even for the non-corporate sector. The current value of a share of stock or a non-corporate business is the present (discounted) value of its future after-tax earnings. If for any reason (reinvested earnings, discovery of a better mousetrap, etc.) future earnings are expected to rise, the current value of the business or price of the stock will rise. If the future income does rise, that added income will be taxed when earned. To also tax the associated increase in the present value of the business is to double tax the future income.

Effects of marginal income tax rates on labor and capital

Taxes on labor and capital income force up the cost of labor and capital, and reduce the quantity offered and employed. The supply of labor is not very elastic. Consequently, much of any tax imposed on labor is borne by the workers. [Chart 3.] Most people must work to have a satisfactory income, and many must conform their hours of work to the requirements of their employers. Moving across national borders is less of an option for labor than for capital. (Workers have some choices—to take or reject overtime, to contribute a second family earner to the labor force, how long to vacation, and when to retire.)



The quantity of capital is more sensitive to taxes than is the quantity of labor. When a tax is imposed on capital, the quantity of capital employed falls until the rate of return rises to cover the tax, leaving the after-tax return about where it was before the tax. The tax is largely shifted to users of capital and those who work with it. [Chart 4.] Capital is easily reproduced (elastic supply) and it takes a large change in the quantity to make a large change in its rate of return. As for people's willingness to finance capital formation, people can always consume instead of save, or invest abroad instead of in the United States, if the rate of return on saving and investment is driven down by rising taxes.

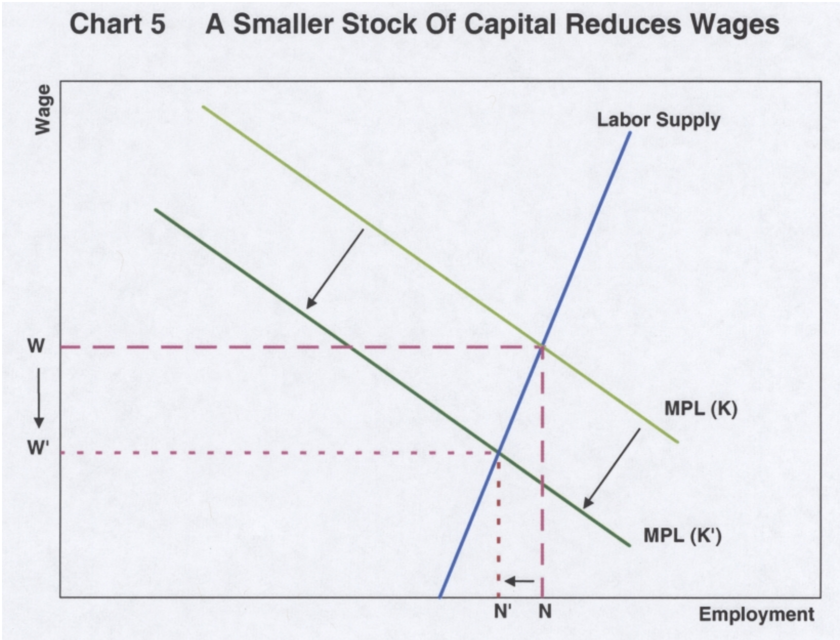


The differences in the elasticities of supply and demand for labor and capital suggest that there is an economic advantage to moving away from the so-called broad-based income tax, which taxes income used for saving and capital formation more heavily than income used for consumption, to various taxes that are saving-consumption neutral.[7]

The tax treatment of capital hurts labor

The more there is of any one type of factor, the higher will be the productivity and incomes of the other factors that work with it and gain from its presence. A tax that reduces the quantity of capital lowers the wages of labor. Labor thus bears much of the burden of the tax on capital. (See Chart 5.) Because capital is more sensitive to taxation than labor, a tax on capital will have a relatively large adverse impact on the quantity of capital, which will then cause a relatively large drop in the marginal product and compensation of labor.

[7] For a further explanation of the biases against saving in the current income tax, see Stephen J. Entin, "Fixing the Saving Problem: How the Tax System Depresses Saving and What To Do About It," *IRET Policy Bulletin*, No. 85, August 6, 2001, p. 15 ff., Institute for Research on the Economics of Taxation, available at www.iret.org. Also see David F. Bradford and the U.S. Treasury Tax Policy Staff, *Blueprints for Basic Tax Reform*, second edition, revised (Arlington, VA: Tax Analysts, 1985).



Consider a small trucking company with five vehicles. Suppose that the rules for depreciating trucks for tax purposes change, with the government demanding that the trucks be written off over five years instead of three. The owner has had enough business to run four trucks flat out, and a fifth part time. He is barely breaking even on the fifth truck under old law. It is now time to replace one of the trucks. Under the new tax regime, it does not quite pay to maintain the fifth truck. The owner decides not to replace it, and his income is only slightly affected. But what happens to the wages of the fifth truck driver? If he is laid off, who bears the burden of the tax increase on the capital?

Several studies in the economic literature illustrate that a zero tax rate on capital income would raise the after-tax income of labor, in present value terms, even if labor must pick up the tab for the lost tax revenue.[8] Productivity and wages would be higher (Chart 4 in reverse), leaving workers with higher gross wages and more after-tax income.

Budget impact

The faster economic recovery since the 2003 Tax Act has improved the budget outlook. For fiscal year 2005, federal revenues ran 14.5 percent, or $274 billion, ahead of 2004 levels. The deficit for fiscal 2005 ran 22.9 percent, or $94 billion, below that of fiscal 2004. There have been large gains in taxes not withheld. These revenues are from non-corporate business income, bonuses and options, and capital gains and dividends. A large part of the improvement in fiscal year 2005 receipts is due to higher capital gains realizations and higher dividend payments.

---

[8] Martin Feldstein, "Incidence of a Capital Income Tax in a Growing Economy with Variable Savings Rates," *The Review of Economic Studies*, 41(4), 1974, pp. 505–513. Christophe Chamley, "Optimal Taxation of Capital Income in General Equilibrium with Infinite Lives," *Econometrica*, 54, May 1986, pp. 607–22. Kenneth L. Judd, "Redistributive Taxation in a Simple Perfect Foresight Model," *Journal of Public Economics*, 28, October 1985, pp. 59–83. Also, see Kenneth L. Judd, "A Dynamic Theory of Factor Taxation," *American Economic Review*, 77, May 1987, pp. 42–48; H. Greg Mankiw, "The Savers-Spenders Theory of Fiscal Policy," *American Economic Review*, 90(2), 2000, pp. 120–125; and Casey B. Mulligan, "Capital Tax Incidence: First Impressions from the Time Series," NBER Working Paper 9374, National Bureau of Economic Research, Cambridge, MA, December 2002. Andrew Atkeson, V.V. Chari, and Patrick J. Kehoe, "Taxing Capital Income: A Bad Idea," *Federal Reserve Bank of Minneapolis Quarterly Review*, Vol. 23, No. 3, Summer 1999, pp. 3–17.

Dividend payments have risen sharply since the 2003 Act.[9] They would rise further if the 15 percent tax rate were made permanent. More companies are paying dividends. Many are raising dividends. More would do so if the rate reductions on their shareholders were made permanent. Added dividend payouts reduce the revenue loss from lowering the rate on dividends already being paid. Under their revenue estimating rules, the JCT and Treasury try to gauge the increase in dividends due to a tax rate cut. This will be new territory for them, however. Furthermore, they do not go on to calculate the reduction in the service price of capital and the resulting increases in investment, employment, and wages, and so they miss the higher tax revenues resulting from the higher incomes.

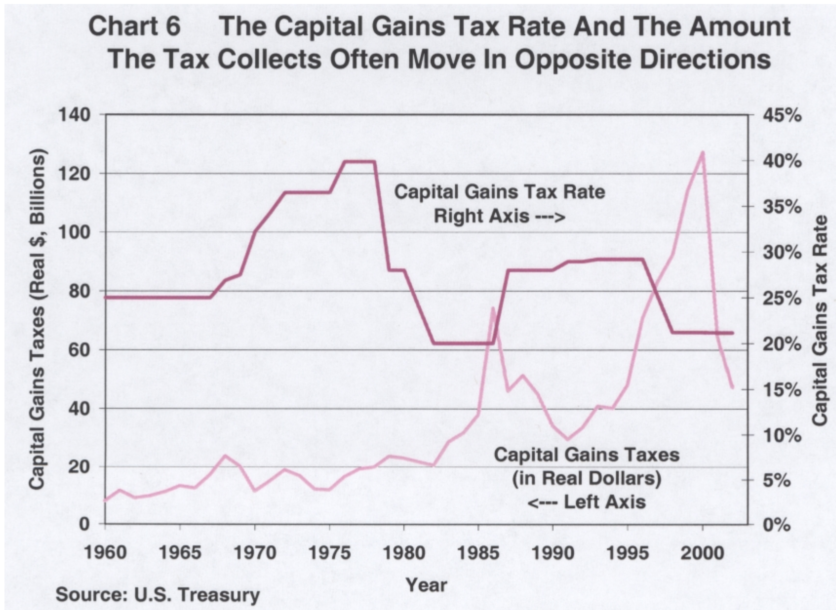
Treasury estimates for extending the 15 percent tax rate cap on dividends beyond 2008 include revenue gains of about half a billion a year from higher dividend payments in 2005–2008. Treasury is acknowledging that some firms have hesitated to raise dividends, or have limited the increases, due to uncertainty about how long the lower rate will last. Extension would boost payouts starting now, adding to short term revenue. Treasury shows losses in the out years from lowering the rates on dividends they assume would have been paid in their baseline. This loss is exaggerated by failure to take account of the economic impact on investment, employment, and wages.

The Treasury, the Congressional Budget Office, and the Joint Committee on Taxation underestimate swings in revenue from tax rate changes on capital gains. A tax rate reduction has three effects: an "unlocking" effect as people choose to realize ("take") more gains at low tax rates; a valuation effect, as the lower tax rate increases the market value of stocks and increases the quantity of gains available to be taken; and an economic effect, as the lower tax rate on capital reduces the service price of capital, and raises the desired capital stock, investment, employment, output, and taxable incomes.

Federal revenue estimators try to account for the unlocking effect under their revenue scoring rules, but they ignore the market effect (stock markets have risen since the 15 percent capital gains rate was enacted) and, most importantly, they ignore the economic effect of the reduction in the service price of capital. In addition, the unlocking effects have generally been larger than the estimators anticipated. Studies in the mid-1980s at Treasury suggested that the reductions in the capital gains tax rate from nearly 40 percent to 28 percent in 1979 and from 28 percent to 20 percent in 1981 have raised revenue.[10] By contrast, the capital gains rate hike, from 20 percent to 28 percent, enacted in 1986, was followed by a collapse in realizations. Long term gains as a share of GDP did not recover to 1985 levels for twelve years. [Chart 6.]

[9] See Daniel Clifton and Elizabeth Karas, "Two Years Later: Tax Cut Still Paying Dividends for American Shareholders", American Shareholders Association, Washington, DC, June 2005, pages 11–12, analyzing Standard and Poors 500 historical dividend data. Also Stephen Moore and Phil Kerpen, "Show Me the Money! Dividend Payouts after the Bush Tax Cut", CATO Institute Briefing Papers No. 88, Washington DC, October 11, 2004.

[10] See the following Treasury Department Papers: the panel study in "Report to Congress on the Capital Gains Tax Reduction of 1978", Office of Tax Analysis, September, 1985; Michael R. Darby, Robert Gillingham, and John S. Greenlees, "The Direct Revenue Effects of Capital Gains Taxation: A Reconsideration of the Time Series Evidence", Research Paper 8801, Office of the Assistant Secretary for Economic Policy, May 24, 1988; Gillingham, Greenlees, and Kimberly D. Zieschang, "New Estimates of Capital Gains Realization Behavior: Evidence from Pooled Cross-Section Data", OTA Paper 66, May 1989, and Gerald E. Auten, Leonard E. Burman, and William C. Randolph, "Estimation and Interpretation of Capital Gains Realization Behavior: Evidence from Panel Data", OTA Paper 67, May 1989, both from the Assistant Secretary for Tax Policy, Office of Tax Analysis; Gillingham and Greenlees, "Evaluating Recent Evidence on Capital Gains Realization Behavior", August 4, 1989; and "The Effect of Marginal Tax Rates on Capital Gains Revenue, Another Look at the Evidence", Research Paper 9003, Dec. 1, 1990, both from the Office of Economic Policy. Also see Gillingham, Greenlees, and Zieschang, "An Econometric Model of Capital Gains Realization Behavior", presented at the 65th Annual Conference of the Western Economic Association, July 1, 1990.



Extending the 15 percent top tax rate on dividends and capital gains now would be excellent insurance against renewed weakness in investment. It would lower the projected service price of capital, and would improve the economic outlook. The revenue consequences would be positive in the short run, and less negative than the static revenue projections from Treasury and the JCT in the long run. More importantly, the effect on the economy, wages, and employment would be sharply positive.

Senator BROWNBACK. Thank you very much, Mr. Entin.

Gentlemen, I appreciate all the testimony. I've got some questions I want to ask each of you.

Congressman Armey, let me start off with you on this. You've been around this topic for a long period of time. There has been widespread support for it. There is enormous frustration about the current Tax Code, across the Nation. I've held town hall meetings on this, years ago, and people are more frustrated with the complexity than with the rates. And then, you note, as well, something that I haven't heard other people testify, just a fear factor here that, "Somehow I'm going to get it wrong, and then somebody's going to come after me for it."

Why have we not been able to get fundamental tax reform, then, with all of that going forward?

Mr. ARMEY. Well, I—of course, I study and worry about this all the time. And I appreciate the question. I think there are a variety of reasons. One, there is confusion in the country about which way to go. There is a large share of our population, a large active and vocal group of people in the country, that believe we ought to have a national sales tax. This dissipates a lot of energy that could be devoted and funneled on this—on the tax reform. And I can just say I've studied on this for years, and I remain even more convinced today than ever before that a national sales tax would be a disaster—an economic disaster, administrative disaster, and a

disaster which, among other things, would result in an enormous growth in the underground economy in this country.

Every good thing that is predicted for a national sales tax, when, in fact, it has been enacted in the world, has failed to materialize. Just the opposite. Every good thing that's been predicted for the flat tax has, indeed, materialized into greater degrees than hoped for.

So, it strikes me one of the things we're going to have to do is finally get ourselves settled on one option, as opposed to flirting with what I, frankly, have to characterize in no other words than patent foolishness, a national sales tax. But that does make it difficult to get a nation focused.

The other is, quite frankly, this Nation is behind the eight ball relative to the relatively new governments in the—and enterprises—in the liberated Eastern Europe, in that we have a very large, effective, and well-focused, and highly well-funded tax complexity system of professionals in the country. And my favorite is, for example—and there's a lot of mythology that they attend to. I always like pointing out that the great myth of the realtors is that the American dream is to own your own home, when, in fact, it is to get your kids out of it.

But we have a group of people whose profession is how to maximize revenues or returns, or whatever, under this existing Tax Code. If the Code goes away, their job goes away, the professionals, who are very skillful and able people in universities, that are responsible for helping people, nurturing them through the process of giving to universities.

And, quite frankly, as Milton Friedman—I'm going to resort to Milton Friedman on this one—as Milton Friedman points out, the two tax-writing committees themselves. I mean, I can honestly say—I've been in Congress for 18 years—I have not yet once heard somebody say, "I would like to be on the Ways and Means Committee, because I'm fascinated with the subject area." The fact of the matter is, the first best reason people want to be on the Ways and Means Committee is, it's the best way, and easiest way, to fund their campaigns, because there is that professional trading of this and that consideration. Now, I don't mean to say their work's not legitimate. Within the context of this Tax Code, it is a legitimate committee that's—that operates, I think, by and large, with legitimate governance. But, two observations: One, it has this aberrant side effect of being—making campaigns easier—more easily funded; and, two, Armey's axiom is that, "Even a sane man will act crazy in crazy institutions." And our Tax Code is a crazy institution.

So, I don't want to be too critical of the committees, but do understand the committees would, themselves, resist this kind of a change, because it would, in fact, put them out of business. And that—so, you've got—you have that system of tax professionals.

Then, the—finally, from a more ideological point of view, there are people in the country who still believe that it is a legitimate and necessary function of the Tax Code, as over and against my belief that it is a corruption of the Tax Code, to use the Code for income redistribution and social engineering. And, again, these poor, misguided souls, in my estimation, simply don't understand, there's

only one legitimate reason to have a Tax Code, and that is to raise money. And, as Adam Smith said, in 1776, that ought to be done in such a manner as to strip the down off the goose with the least amount of squawks. And our Code doesn't do that.

Senator BROWNBACK. Mr. Edwards, I want to focus in on Hong Kong, because they have this optional flat tax system, and I want to ask you about that. First, what's the rate in Hong Kong?

Mr. EDWARDS. Yeah, they have a graduate individual system, with rates that go from 2 to 20 percent. So, their top rate, under their regular system, is not that high. And if your—effectively, your effective tax rate rises above their flat 16 percent rate, you pay, at most, 16 percent on a broader income tax base.

Senator BROWNBACK. So, they basically have an alternative maximum flat tax?

Mr. EDWARDS. Basically, that's how it works, yeah.

Senator BROWNBACK. Because I've heard other people say that's what we ought to do with the AMT, make it into an alternative maximum tax and just——

Mr. EDWARDS. Yeah, the AMT certainly has lower rates in the regular system, and a broader base.

Senator BROWNBACK. What about people opting in and opting out of the Hong Kong system? Do you know the numbers, or have you studied that? And do people bounce back and forth in that system, then?

Mr. EDWARDS. I think that's allowed. In fact, I think it's—my understanding, from Allen Reynolds, my colleague, who's more of an expert on the system than me, is that it's essentially—the tax authorities do the calculation for you. If your return goes in, and you pay—and you've got higher than 16 percent effective rate, essentially you're—you know, that's the cap, that's the most that you can pay. So, it's—they've essentially enshrined the principle that no one should pay more than 16 percent of their income in taxes.

Senator BROWNBACK. Dan, what should the flat tax rate be here in the District of Columbia? I notice you poked your colleague, Congressman Armey, as asking for too high of a rate. What should it be in the District of Columbia, other than, obviously, as low as possible?

Dr. MITCHELL. Well, you took away my obvious answer right there. Frankly, you have a tradeoff. The lower the rate you have in the District, the better the economic growth results, the more this will be a pilot program that'll get the rest of the country excited. But, I think Steve Entin correctly warned you that the Joint Committee on Taxation is going to get all nervous about that, because what they will do is make assumptions about huge amounts of people moving into the District, and, therefore, Federal tax revenue collections from, say, Maryland and Virginia, going down. So, they're not just going to look at the existing tax base in the District and not give you a very friendly score on that, and not count the economic growth effects, as Steve mentioned. But they're going to say, "If it's so much more attractive, because the rate is so low in the District, it's going to—you're going to bounce into some very difficult issues with the revenue scoring, simply because we've never fixed that process."

Senator BROWNBACK. Do we have an example of anywhere in the world that's gone to a flat tax that has not produced positive economic growth numbers?

Dr. MITCHELL. Well, I can best—for instance, Serbia—I've never studied that system. I have no idea how well it works. You know, the countries that are in, you know, closer to the west, and the bigger countries, are the ones that have gotten the most attention. And, of those, unquestionably, big revenue increases in Russia; Slovakia, same thing. Romania has only been in effect just a little bit over a year; they've had very good results. The three Baltic countries, very, very positive results over time.

Senator BROWNBACK. So, a flat tax creates positive economic growth and tax receipt growth.

Dr. MITCHELL. Both economic growth—the key relationship is faster economic growth means a bigger tax base. There's just more income out there to tax, so, even though it's at a lower rate than it might have been under the old system, because people are doing two things, the government can come out without a loss of revenue. Number one, they're not evading and avoiding the tax system as much. And, number two, they actually have better incentives to work, save, and invest. And the combination of those two factors have resulted, especially if you look at the better, more purer flat tax systems—you know, not all these systems, as Steve said, are Hall-Rabushka-style systems—but, say, Estonia, Slovakia, Hong Kong would probably be the three best systems that are the most pure. And we've unambiguously had superb results from those jurisdictions.

Senator BROWNBACK. Both substantial economic growth and substantial increase in tax revenues.

Dr. MITCHELL. Uh-huh.

Senator BROWNBACK. Even though this, here will be scored by the Joint Committee on Taxation, static, and so, will probably be scored as a net revenue loser to the Government.

Dr. MITCHELL. Yeah. I mean, it depends on your definition of "substantial revenue." Slovakia, I think you're talking about a half a percent of GDP income tax collections being above the static forecast. In Russia, it's been much more dramatic, but they start it with a bigger problem of tax evasion. You know, so it just depends on what your base is, what you're factoring in. But certainly we have not seen anything that could be characterized as a loss of revenue. The revenues come in over forecast in all the situations I'm aware of. Again, I don't want to pretend that I know the intricacies of Ukraine and Serbia, other than knowing that they have one rate. I have no idea how well the systems work. They obviously have a lot of other issues and challenges in those countries. And so, there's just not good data coming out.

Senator BROWNBACK. Let me turn to my colleague. We're joined by Senator Allard of Colorado.

Senator ALLARD. Well, thank you, Mr. Chairman.

And I want to welcome the panel. I want to apologize that I wasn't here at the start of your hearing. It wasn't that I wasn't interested. It was that I had a budget hearing going on at the same time, and I wanted to get there and get my two bits in before I had an opportunity to come here.

And I want to also compliment you on working hard to simplify the Tax Code, particularly as it applies to Washington, DC. I have always been one who has felt that we needed to have tax reform in this country. I have felt that, in addition to that, we need to be sure that we reduce the tax rate. In other words, we not have tax reform, then end up increasing the tax rate.

The State of Colorado, from which I represent, has a modified flat tax that they use. It's built off of the Federal income tax. It does simplify filling out the tax form for many citizens in the State of Colorado. The disadvantage, of course, is that they tie their tax policy somewhat to the Federal level. And that tax policy is not always wise, in my view.

I do think that to apply a flat tax to Washington, DC—and I think of—we can think of it in terms of a State—I think it's less problematic than it is for the State of Colorado, because they're so closely tied in with the Federal budget anyhow, and they are—basically have to answer to the Congress. So, I think it's a wonderful idea. And I hope that we can get this to sell here in the Congress.

There's been other tax reform measures, as was alluded to by Mr. Armey here, in his comments, the sales tax reform. Most of that idea was actually promoted in the House of Representatives, when both Mr. Armey and I served over in the House, from my good friend from Colorado, Congressman Schaefer. And he was a strong advocate of the sales tax. And I've—I took the position that we probably shouldn't be advocating or going with a sales tax, unless we can assure ourselves that we don't end up with a double-tax system. And that required a constitutional amendment to eliminate the income tax provisions. Otherwise, I felt like we could temporarily eliminate the income tax, put in place a sales tax at the national level, and then, a decade or two later, we'd inevitably be back with an income tax again. We'd have a two-tax system. And I think we'd be much worse off than we are today if that should happen.

So, I've always had some reservations about the sales tax. And the argument was always, "Well, you could get rid of the IRS." But if you have a sales tax, you'd have to have an auditing function. And that means—I looked at it from a perspective of a small business man. I already have—if I have a sales tax, I already have the State auditors coming in, and the city auditors coming in. Now I've got to have the Federal auditors come into my small business and look at it? I didn't—I wasn't—I didn't shine on that too well.

I think the most practical and the—approach to tax reform has to be the flat tax. And—now, the proposal that we have over on the House side was a flat tax—it was a modified flat tax. We had a couple of exceptions. Number one was the mortgage—the interest on mortgages of homes, and also charitable giving. And I don't know whether you're talking about those exceptions or not here on the District of Columbia bill.

Senator BROWNBACK. Well, this would be a straight flat tax——

Senator ALLARD. Flat tax.

Senator BROWNBACK [continuing]. Option, so that you keep the current Code, but you also create the option, but the option doesn't have any—it doesn't include mortgage deductions, charitable deductions, it is a flat rate, period.

Senator ALLARD. Flat tax, yeah. And that might——

Mr. ARMEY. Let me just——

Senator ALLARD [continuing]. Work a little better, because——

Mr. ARMEY [continuing]. Interject that the retention of the mortgage deduction and the charitable deduction may end up being a political reality.

Senator ALLARD. Right.

Mr. ARMEY. But it is dumb tax policy.

Senator ALLARD. Yeah. Well, I mean——

Mr. ARMEY. And there is, in fact, no justification for doing so, in terms of your desire to see more charitable contributions or to see more people own their homes. But the fact of the matter is, these are two very, very strong, powerful lobbies, and they sell their—as we say in Texas, their BS very well.

Senator ALLARD. Well, and I'm assuming that your flat tax is going to be somewhat like Colorado's, you're going to tie it into the Federal. And if you do that, it's not a problem.

Mr. ARMEY. Right.

Senator ALLARD. It's already there. So, I appreciate it.

I—do you—let me just ask this, sort of, generic question to the panel. Well, let me—before I do that, let me—I think the President has us on the right approach on tax policy, particularly on two of the taxes. Number one, I think reduction of capital gains worked again, as it did for the Kennedy administration, when John Kennedy implemented it, and when it happened with the Reagan administration, when President Reagan implemented it. And I think we saw it work again. And we saw it work, even when we had some adverse economic events happening. We had high energy costs. I remember, in 1970, with high energy costs, we ended up with a misery index—double-digit unemployment, double-digit inflation, double-digit interest rates. And, you know, his tax policy worked, and created growth, even in the face, not only of high energy costs, but also paying for a terrorist war out here. And I think that speaks to the strength of his policy. And I think one of the strongest aspects of it was the aspect where we allowed expensing for small business, up to $100,000. To me, that was a real income driver. It was a driver for small business, a driver for our economy, and, I mean, the Federal revenues went up. And so, I just wanted to make that—get that two bits in.

But let me ask you, Do you—ask this panel—do you see any down sides for having a flat tax here in Washington, DC?

Senator BROWNBACK. If I could, Senator—and I want the panel to answer this—I've got a markup, upstairs, in Immigration, I've got to slip up to, to get them a quorum. So, I'm going to turn the gavel over to Wayne to do that. And I appreciate very much the panelists being here. I may be able to come back down. But I think it's been excellent discussion.

I do hope, as well, that you talk with them about the issue of charitable giving, because people raise the issue of, "Isn't this going to make a hit on your charitable giving?" So, I hope we can address that, some, as well—if you don't mind taking over——

Senator ALLARD. Sure.

Senator BROWNBACK [continuing]. To charity.

Senator ALLARD. I'll be glad to. Is there any other questions you want me to cover?

Senator BROWNBACK. Just on the charitable giving, because I think it's important to get that out in the record.

Senator ALLARD. Yeah.

Mr. ARMEY. Let me——

Senator ALLARD. If we run out of——

Mr. ARMEY. Let me respond to both points. The first quick short answer to yours, on the downside question, is, the answer is no. I see nothing but good things for the city. I can see that some of the areas around the city might not be real happy, but the city—I don't—I can't conceive of a down side for the city, especially when you recognize the voluntary subscription aspect.

Now, let me just talk about the charitable giving thing, because it's been kind of a pet peeve of mine for some time. When we did the Reagan tax cuts, we cut the tax benefit of charitable gift to one-third of what it had been prior to the Reagan tax cuts. And charitable giving went up. The reason charitable giving went up was, people's incomes went up. Revenue to the country doubled in the decade of the 1980s in the aftermath of the tax—Reagan tax cuts.

The fact of the matter is, what happens with charitable giving is that, once again, as with investment activity, you get—you will get more charitable giving, and it will be given—the decisions, the choice criteria, where and how much to give will be made on charitable criteria, rather than tax criteria. And I just have to tell you, anytime you have a decision made on economic criteria, criteria of the heart, criteria of the mind, you're going to have better choices and better results than when you have decisions that are made on political criteria. This, I say to you, pursuant to Armey's axion number none, "The market's rational, the Government's dumb." And people, when they're guided by the need to maximize my well-offness in terms of Government policies, are not going to make the same rational, and, I would say, equally free, decision.

My—for example, I might find—I find this interesting—if I had a—under American tax law today, if I—it would make more sense for me to give $12,000 to the Society for the Prevention of Cruelty of Animals than to a relative that's not well off, because the animals will not be, then, in turn, required to pay taxes to the Government under $12,000, and my relatives would. Now, I mean, you've got a tax law that says, now Dick Armey wants to make a decision of the heart, he'll put people before animals; if he wants to make a decision compliant with the Tax Code, he puts animals before people. This is why—now, I know it sounds harsh for me to say the word "dumb," but I just, frankly, can't find much of another word to use.

Senator ALLARD [presiding]. Other members of the panel who would like to respond to the question?

Mr. ENTIN. Yeah.

Senator ALLARD. Mr. Entin, and then Dr. Mitchell.

Mr. ENTIN. I don't want to sound "dumb"—but there are some other principles of sound tax theory that I think we need to consider. My late boss, Norm Ture, who was a tax expert here in the city for many years, was a strong advocate of these neutral taxes, but he also wanted to put the principle forward that income should

be taxed as close to the level at which people get to spend it as possible. So, that if, for example, someone is paying alimony to an ex-spouse, the alimony comes off one's tax return and goes onto the tax return of the recipient. Similarly, with charity, if I'm giving money to someone else, it should come off my tax return and go onto theirs.

Now, under the flat tax, and most of the variations of it, including that which Senator Brownback has described, there would be an exempt amount for the poor—in fact, quite a generous one—so that if people receiving income are too poor to owe tax on it, they shouldn't have to pay tax on it, nor should it be taxed before they get it.

So, the point is that you really—for the maximum amount of visibility and transparency in the tax system, you should probably tax them on a—at the point where the people who are spending it can see that there's a tax imposed. So, I would differ, on that basis.

I would agree that the fuss that the special interests made over the mortgage interest deduction was just a bunch of a hullabaloo. If mortgages are at 8 percent, and the borrower and the lender are in the 25 percent tax bracket, they're both paying and getting 6 percent, after tax. And if you have the flat tax, they simply go to a 6 percent rate to start with. It seems to me that was very much a slander against the flat tax on the part of the retailer—the realtors.

I would be more concerned with the loss of the deduction of the property tax. If you're a business, it's clearly an expense. And taxable income should be revenues minus the cost of earning revenues.

But there's another consideration. Most of the neutral taxes would regard tuition as a cost of earning future income. It's an educational outlay. It's an investment in human capital. You're expensing physical capital. You should expense the tuition. To a large degree, the property tax deduction does that for primary schools. And the State tax deduction does that, to a considerable degree, for State universities. And much of the rest of those taxes goes to transfer payments to the poor.

So, I think those are reasonable, on other principled grounds. I don't agree that we would have a collapse of charitable giving if we denied the deduction. I think that most of the ordinary arguments made against the Armey plan on those bases are phony. I just have this other kind of tax consideration that leads me to conclude that those should be kept.

Chris made a statement about the alternative minimum tax, in response to Senator Brownback's question about an alternative maximum tax. I have some serious reservations about the AMT. Again, it disallows some legitimate business deductions, so it's overstating the business's real income, and that of individuals, in many cases. So, you're taxing something, but it's not income. I don't know what it is, but it's not income, after costs. And, yes they do lower the rate in the statute, but they have a large chunk of exempt amount under the AMT, which they phase out between two levels of income. If you're in the phase-out range, you're not paying the 26 and 28 percent tax rate, you're paying 32½ and 35. And in that range, your rates are as high, or higher, than under the ordi-

nary income tax, at the margin. It is really not a good alternative tax system. If you're going to do an alternative tax system, do the Hall-Rabushka or do the consumed income tax, but don't do the AMT. That's not a good way to go.

Now, there are two other neutral tax systems, the VAT and the national retail sales tax. I don't think you could adapt either one of them, as they are normally put forward, to be a test case for the District of Columbia. If you tried to put a major sales tax, at the Federal level, on the District of Columbia, people would drive to Maryland to get their groceries. You'd have to have Customs sheds and checkpoints at all the roads between the District and Maryland, and on the bridges to Virginia. I don't know what you'd do at the airports. They're crowded enough.

If you tried to do the value-added tax on the normal basis where you exempt exports and tax imports, you'd have the same customs shed problem. And you could perhaps do it on an origin basis, which is the opposite of the way VATs are treated all around the world. So, I think there are administrative problems with those other approaches.

And there are some administrative problems in translating the flat tax into a regional tax, or a consumed income tax into a regional tax, that you would have to address carefully in the legislation.

I do think that the effort to get this discussion going as to why the tax systems are too complicated and antigrowth is very important. And if you can come up with demonstration legislation that takes care of these administrative details that would otherwise drive the Treasury nuts, you know, more power to you. I do commend you for being interested in the issue and trying to get something done to blast it off dead center.

Thank you.

Senator ALLARD. Well, it is a more simplified tax, when you go to a flat tax. Like, in Colorado, you just take the bottom line off your Federal income tax form. I think the rate's 6 percent or 6½, something like that. Just multiply that out, and you've got what you pay in the State. You can do it on a postcard, if you don't have a complicated tax form. If you have a complicated tax form, you're not going to get it done on a postcard.

Dr. Mitchell.

Dr. MITCHELL. I was just going to add a couple of quick points. Only about 30 percent of people in the country itemize, as it is. So, 70 percent of the people who are homeowners, people who give to charity, they're not doing it for the tax benefit, clearly, at all. And to echo what Congressman Armey said, we had an actual experiment in the 1980s. If itemized deductions really were critical, then we should have seen terrible results for housing and for charity in the 1980s, because marginal tax rates, and, therefore, the value of the deduction, fell so dramatically. Instead, we saw just the opposite. Why? What matters for charity, what matters for housing, what matters for just about everything in the country, other than maybe bankruptcy law, is strong economic growth. If you have people earning more income and people generating more wealth, they're going to give more money to charity, they're going to buy

bigger homes, more homes, and that should be the key thing about tax policy.

Raise revenue in the least destructive way possible so you can have the maximum economic output, big tax base, low tax rates. That's the fundamental principle of taxation, that—I'm just afraid that we're forgetting about, while the rest of the world is catching up. And sooner or later, a country like China's going to adopt a flat tax. I mean, we can look at Slovakia, be impressed by their results, but that's not going to have a big echo effect on our competitiveness. It's going to spread. It's going to keep spreading, because of globalization, and I just worry that we're going to fall behind while other countries are doing this.

Senator ALLARD. Mr. Edwards.

Mr. EDWARDS. Yeah, to build on that a little, I mean, Senator Brownback's first question to Mr. Armey was, you know, why has there been these big hurdles to tax reform? And why haven't we got it done yet? And it does seem to me, looking ahead—and I agree with Dan entirely—that, you know, in some ways, it should get easier to do a big tax reform in the future, because the gap between the most efficient tax systems, the highest-growth countries in the world, and us will get larger and larger. Global capital flows will keep going up and up and up and up, and that means that the cost of not having an efficient tax system will rise. And as more—right now, for small- and medium-sized countries, like in Eastern Europe, there's a compelling economic interest in radically cutting your tax rates, because you're a small country within a gigantic global pool of capital. So, the United States has been somewhat resistant to tax reform, because we have such a big economy and because investors want to put money here for nontax reasons. But as other countries catch up and keep cutting, like China, the pressure on us will rise and rise. And that's why I think, you know, sometime in the future we will get a flat tax. You know, maybe not in this year or next year, but I think the pressure will keep rising.

Mr. ENTIN. Chris has made an important point about the international capital flows and the global economy. I'd like to bring that down to a specific problem you may face here, and that the President may face. The President's proposed that the Treasury begin doing dynamic analysis and get away from the static estimates. Chairman Thomas, in Ways and Means, has been trying to get the Joint Committee on Taxation to do that for some years. The people doing these analyses from the old guard in the tax theoretic community tend to look at a closed economy. They tend to neglect the international capital flows. They tend to assume that domestic saving isn't responsive to these incentives, and that, therefore, if you did get investment incentives, there would no money to pay for it, unless the Government ran huge budget surpluses, which we're not going to do.

The smaller countries adopting these proposals are attracting capital from abroad, and they can get the use of other people's saving. If the French are not investing very much in France, they can invest in Slovakia. If the taxes in France aren't doing a good job for their local investment, the savers in France can just invest somewhere else. The United States sends a lot of money abroad into global mutual funds. If we improved our tax climate here, that

money might stay home. Wouldn't be any additional savings in the world, but we'd be getting to use it more than the others. Foreign saving could flow in.

When you do these changes that make investment in the United States look more attractive, the saving materializes. And those on the static revenue side who don't want to bother thinking about that, and some of those who are supposedly doing dynamic analysis, but still think about closed models where they don't have these savings flows, are going to come up with the wrong answers.

So, if Treasury doesn't do it right, this effort won't work well. And if the Joint Committee on Taxation continues to do it wrong, they may claim they're doing dynamic analysis, but they're not doing it correctly. And they will still give you bad outcomes on the bills that you put forward to make the country grow, which will make it look like it's too expensive to do them. It's really too expensive not to do them.

I really think that the Congress needs to take the Joint Committee on Taxation in hand, and I hope the administration will take the Treasury in hand, when it tries this experiment, so that it gets done right.

Senator ALLARD. Well, I agree with you, in your comment. Again, one of the frustrations I had in coming to the Congress is the static scoring that they did. And it disadvantaged—basically, it disadvantaged any of those who were proposing a tax reduction. In Colorado, we have dynamic scoring. And I think we did as good a job as they do here at the Federal level in coming up with what—they actually did a better job than they actually were coming up here at the Federal level, as far as projecting what the incomes would be from the policy changes that we were making.

The—and what we did in Colorado is that we followed the—you know, when we projected income and expenses, we followed those. And if we saw them moving in a way that was going to create—we have an amendment that says that we can't run the deficit in our budget. So, then, if we saw that, at some point in time during the fiscal year, where when it extrapolated out to the end of the year, showed that we're going to end up with a deficit, we would begin—institute a policy change in the middle of the year, even if it required a special session of the legislature, so that we could change it before we got to that point where we had a deficit at the end of the year.

So, I thought—and—but, you know, I can only think of once where we had to come in and change that just before we adjourned. Actually, we didn't even have to call a special session; just before. But other—the 8 years I was in the State Senate there, I thought it worked extremely well for us. And I think once you get people familiar with the process and familiar with the dynamic scoring methods that work, then the tradition can carry on. And I think it will work for us. And I like the idea of dynamic scoring, because I think you remove the prejudices out of the system. And I think when you go with a static scoring, you build in some prejudices that disadvantage those of us.

And on flat—on the AMT and the telephone tax, there's two examples of where you're going to tax the rich. And we ended up taxing everybody, because everybody grew their revenues up to the

point where they reached into those parameters. We've seen that happen time and time again. And that's the argument that we have on the flat tax. I can see it coming. "All you're doing is, you're going to help the wealth, and the poor are going to continue to pay their taxes." And that's the argument, as Mr. Armey knows, that we're going to be facing here. And if you have a good—you know, I—my response to it, obviously, is that, you know, when the tide rises, everybody benefits. If you have a better argument on that, I would certainly like to hear what that might be, when we get that argument that all we're doing is benefiting the wealthy. They'll use that argument in any tax cut that we do, by the way. But if you have any suggestions, I'd like to hear what you have.

Yes, Mr.——

Mr. ARMEY. Why don't I just say, you know, there's a great—fascinating mythology of American tax discourse—and, of course, a great lie, and it probably has some truth to it—most wealthy people have many avenues by which they can shelter or otherwise disguise, and, therefore, abridge their tax liabilities. And the flat tax eliminates everything that can be described as a "loophole." So, I mean, I laugh at the people—my good friend Charlie Rangel being the most colorful of these—and I do say this sincerely; I love Charlie Rangel like a brother, but he is funny—in that, on one hand, "All my rich friends"—he's talking to me—"all my rich friends got them loopholes that you guys put in, you Republicans, put in for them." And then we want to talk about passing a flat tax, where there are no loopholes, "Well, that's just another thing you're doing for your rich friends." So, Charlie, he's going to have it that way, either way.

But one little thing we picked up during one of the Presidential campaigns when we had a lot of colorful campaigning going on, was, somebody took the time to figure out Ross Perot's tax liability. During that year, his tax rate was 11 percent. And had Ross Perot filed under the flat tax in that year, he would have paid 17 percent. So, I know that's only one instance, but I have to say it was quite fun for me to traffic that one around during that period of time.

Senator ALLARD. Mr. Entin.

Mr. ENTIN. In addition to analyzing things dynamically to estimate revenues, you really need to—well, if you did that, you would need to know what would happen to the economy and to people's incomes as a result of the tax change. When you cut taxes on capital, more capital is formed. Old capital has more competition from the new capital. They don't gain very much.

Senator ALLARD. Yeah.

Mr. ENTIN. But with the new capital in place, labor's more productive, and the wages are bid up, and so is the number of jobs. Most of the gain from reducing taxes on capital goes to labor. There's quite an economic literature building on this now. So, all of those distribution tables and burden tables, that the Joint Tax people give you, that don't assume any change in wages when you cut the taxes on capital, and just show the initial impact of the tax change on who sends the check in to the Government, are not burden tables at all; they're initial incidence tables. If you did the burden table correctly, which you have to do, to do dynamic scoring, you'd show labor getting the bulk of the gain from moving to some-

thing like the flat tax. You need to reform the Joint Committee on Taxation in more than one way, is what I'm trying to say. And if you did that, you'd get the very result that you described earlier.

Senator ALLARD. Thank you.

Mr. EDWARDS. To put that in a quick principle to sort of remember here, is that the more mobile the tax base, the less likely that the burden actually ends up being paid by that tax base. The classic example is the corporate income tax in the global economy. Probably much of the burden of the U.S. corporate income tax falls on U.S. labor, not on U.S. capital holders. High-income individuals generally have much more mobile tax bases than low-income taxpayers. If you try to—the more you try to tax the rich, they've got many more options to try to avoid taxes—by changing their type of income, by moving income abroad. So, you know, folks may think they're—some folks may think you're going to gain a lot by taxing the wealthy and taxing corporations, but you don't, because they've got a lot more options than average taxpayers.

Senator ALLARD. Yeah, corporations, too. In fact, that's one of the challenges, whether it's the State or Federal. If you look at how much corporations pay from year to year, there's a big oscillation back and forth, and they have the capability of moving around their income more than individuals would have.

Dr. Mitchell, were you going to—did you have a—were you going to respond?

Dr. MITCHELL. I think my panelists——

Senator ALLARD. Okay.

Dr. MITCHELL [continuing]. Did an excellent job.

Mr. ARMEY. Well, I just—I did want to make the point that all this was known to us in the works of Bastiat and Mills, in the last 18th century. So, we keep working at it, we might understand as much as they did in 1776.

Senator ALLARD. Yeah. Very good.

Well, let me just draw this to a conclusion. I know you're all busy people, and I want to thank you for taking the time from your busy lives to come here and help inform us about the proper tax policy that we ought to be pursuing. And I, for one, will be working with the chairman of the committee to see if we can come up with a good flat tax policy here for Washington, DC. Thank you for your testimony, and have a safe trip home.

ADDITIONAL SUBMITTED STATEMENT

The subcommittee has received a statement from Paul Strauss which will be inserted in the record at this pont.

[The statement follows:]

PREPARED STATEMENT OF PAUL STRAUSS

Chairman Brownback, members of the Subcommittee: I thank you for the opportunity to present this statement for the record on the subject of the proposed D.C. flat tax. I am disappointed that the committee will not be hearing testimony from any individuals or officials who represent the District of Columbia. Given that the flat tax, if adopted, would apparently affect only the citizens of D.C., I would hope that you would consider their needs and concerns above the theories of ideologues. The Honorable Dick Armey may know about the Great State of Texas, but he's no expert in D.C.'s taxes.

It is worth noting that the 16th amendment provides that there shall be a uniform system of federal income taxation. Imposing a flat tax on D.C., and only on

D.C., is not only in violation of the spirit of that amendment but also smacks of elitism, by imposing an unfair system on those citizens who do not have a vote to change it. Whether Congress' plenary power over the District would trump our constitutional rights under this amendment is a question that would likely need to be resolved by our courts.

While national tax policy is, of course, within the purview of the national legislature, it would be unconscionable to impose an unwanted flat tax system on the people of D.C. The proposed flat tax could destroy the economic stability of the District of Columbia by taking from those who already have too little and giving to those who live in the richest parts of the city. D.C. is in an even worse position to deal with a flat tax than other places would be because of our unique situation. Unlike a large state, in which there is not only a sizable middle class but a diverse economy with industries that would not be so harmed by switching to a flat tax, D.C. has an economy centered on real estate, government, and nonprofit work.

Flat tax systems typically remove deductions such as charitable contributions, the Earned Income Tax Credit, and deductibility of mortgage interest. D.C. has a dynamic economy; the leading source of revenue is real property taxes. Additionally, we have an unusually large number of people employed in the non-profit sector. If the flat tax eliminates these exemptions, the D.C. economy could suffer tremendously. Consequently, there would also be less tax revenue flowing into local coffers as well as the national treasury than under the current system.

It is morally wrong for Congress to use D.C. as an “experiment.” However, that point aside, D.C. is not even a good subject for experimentation because of the unique economy of the city. It is also wrong to pick on D.C. to experiment simply because we don't have a voting representative in this body. I also find it alarming that this Congress, which has all but bankrupted the federal government, now wants to change the system in D.C., which has a budget surplus. Perhaps instead of national tax experts testifying on how to change D.C.'s federal tax systems, Congress would do well to have the District of Columbia's financial management team give suggestions about how to improve our national economy.

Thank you again for the opportunity to offer testimony in opposition to this proposal. In closing, let me thank Kasey Dunton of my legislative staff for her help in preparing this statement.

SUBCOMMITTEE RECESS

And I'll go ahead and call the subcommittee—in recess—recess the subcommittee. Thank you.

[Whereupon, at 3:25 p.m., Wednesday, March 8, the hearing was recessed, to reconvene subject to the call of the Chair.]

POTENTIAL EFFECTS OF A FLAT FEDERAL INCOME TAX IN THE DISTRICT OF COLUMBIA

THURSDAY, MARCH 30, 2006

U.S. SENATE,
SUBCOMMITTEE ON THE DISTRICT OF COLUMBIA,
COMMITTEE ON APPROPRIATIONS,
Washington, DC.

The subcommittee met at 1:34 p.m., in room SD–138, Dirksen Senate Office Building, Hon. Sam Brownback (chairman) presiding.

Present: Senator Brownback.

OPENING STATEMENT OF SENATOR SAM BROWNBACK

Senator BROWNBACK. Good afternoon. The hearing will come to order. Thank you all for joining us today. Today we are going to continue to explore how the Federal Government might test a fairer, simpler flat system in the District of Columbia. I might also mention at the outset I have offered numerous times if people in the District are concerned about being a test case, I would offer my State of Kansas to be also in that pool of people to be tested for this prospect.

We are going to dig into more of the specifics today. A few weeks ago the subcommittee heard testimony about how a voluntary flat Federal income tax for District of Columbia residents could give us some valuable real world information about whether a flat tax is actually better than the current cumbersome system and I believe also helpful to the District of Columbia.

I believe most taxpayers in the District of Columbia would greatly welcome this opportunity. But since we do not believe that the Federal Government should merely impose a new system on D.C. taxpayers overnight, I would suggest that this be voluntary, that those who want to stay under the current system should feel free to do so.

April 15 is right around the corner and taxpayers across the country are spending their evenings and weekends racing to complete their tax returns. This is no small task, given our complex and complicated and many times unreconcilable Tax Code. Most taxpayers are confused by the 800 different IRS tax forms and the hundreds of pages of IRS instruction books. Adding to this burden is the real fear that taxpayers suffer wondering if they will make a mistake trying to calculate how much of their own money they have to hand over to the Federal Government. They also become suspicious that the existing maze of credits, and exemptions is unfair and gives some special advantage to those who wield political power or can afford an expert tax adviser.

There are two principal arguments for a flat tax, economic growth and fairness. Earlier this month economists testified before this subcommittee that the current tax system, with its high rates and discriminatory taxation of saving and investment, stymies economic growth, destroys jobs, and lowers incomes. By lowering tax rates and ending the Tax Code's bias against savings and investment, witnesses said that a flat tax would boost the economy's performance.

Of course, I would like to see a fairer tax system for all taxpayers in every American city, particularly for my taxpayers in Kansas. But while everyone talks about the need to simplify the Tax Code, real reform has been blocked by those who come up with every kind of excuse to prevent us from fixing the broken system or even testing a new one.

I believe that the Federal Government can pilot a first-ever flat Federal income tax here in the Nation's Capital because of the unique constitutional relationship it has with the District of Columbia. One result of Washington, DC, being the seat of the Federal Government is that over 40 percent of all District property is not subject to local taxation. I repeat that again: 40 percent. By Federal law, the District is precluded from taxing income at source for those workers who are not residents of the District. The result is that 70 percent of income earned in the District cannot be taxed to support District municipal services. Let me repeat that number: 70 percent cannot be taxed.

So to some extent these Federal restrictions on the District's taxing authority have led city leaders to impose very high local income tax, property, and sales taxes. In fact, for decades residents of Washington, DC, have endured one of the Nation's highest tax burdens. As the District's population has steady declined, the tax burden on those who have chosen to stay has become heavier and heavier.

I believe that a voluntary flat Federal income tax would create more economic activity and jobs in the District, which would enhance the District's ability to raise revenue while actually lowering its own high local taxes.

I look forward to hearing from our panel of local District of Columbia experts about how a flat Federal income tax would affect the District of Columbia, and that is what the focus of the hearing today is about. First to testify will be Dr. Natwar Gandhi. He is Chief Financial Officer (CFO) for the District of Columbia, a very well known individual that has worked quite hard and well in getting the city's financial structure back in shape. He is responsible for the city's finances, including its approximately $7 billion in annual operating and capital funds.

As the independent CFO, Dr. Gandhi manages the District's financial operations, which include tax and revenue administration, the treasury, comptroller, and budget offices, economic and fiscal analysis, and revenue estimation functions, and agency fiscal operations.

We also have Mr. Terence Golden and Mr. John Hill, President and CEO respectively of the Federal City Council. It is a nonprofit, nonpartisan organization dedicated to the improvement of our Nation's Capital. Federal City Council is composed of and financed by

200 business, civic, professional, and education leaders. Mr. Golden is also Chairman of Bailey Capital Corporation of Washington, DC. It is a private investment company. Mr. Hill served as Executive Director for the District of Columbia Control Board from May 1995 to June 1999.

I want to thank you all for being here and testifying today. I think we will run the clock at about 6 minutes. I do want to be able to get to some series of questions, but the focus of today's hearing—we talked about the theory at the last hearing. I would like to see the practical impacts in Washington, DC, of such an effort and that is what our primary focus will be today.

Dr. Gandhi, delighted to have you here and the floor is yours.

STATEMENT OF HON. NATWAR M. GANDHI, CHIEF FINANCIAL OFFICER, GOVERNMENT OF THE DISTRICT OF COLUMBIA

ACCOMPANIED BY JULIA FRIEDMAN, Ph.D., CHIEF ECONOMIST, GOVERNMENT OF THE DISTRICT OF COLUMBIA

Dr. GANDHI. Thank you, Mr. Chairman. Mr. Chairman, good afternoon. I am Natwar M. Gandhi, Chief Financial Officer of the District of Columbia. I am here to testify on the matter of the fiscal relationship between the Federal Government and the District of Columbia and to discuss your idea for a voluntary Federal flat tax for District businesses and households. I am joined on my left by Dr. Julia Friedman, our Chief Economist.

A voluntary Federal flat tax may add to the desirability of the District as a place to live and work. However, it will also give rise to additional challenges within the District as more activities compete for the limited amount of available space. In this testimony, I will speak in general terms about the concept of a voluntary Federal flat tax in the District. If a legislative plan is presented by the Congress for implementing a flat tax in the District, I will work with the Congress to provide analysis of the plan.

Consistent with my role as the District's independent Chief Financial Officer, my testimony will only address the fiscal and economic impact of the flat tax. I will not discuss the political or social policy aspects of the flat tax since that role is reserved for the elected officials of the District.

As the Nation's Capital, we enjoy national galleries, monuments, and parks that are the envy of the world and that attract millions of tourists and business travelers. These travelers and the government that draws them create the economic and fiscal basis of the city. The Federal-city relationship is complex and not without problems, particularly in the fiscal arena. The rules are well known, that the District has the jurisdictional responsibility of a city, county, State, and school district while it has only the tax base of a core city.

There is a mutually beneficial relationship between the District and the Federal Government stemming from the District's position as the home of the Federal Government. At the same time, D.C.'s complex jurisdictional responsibility and limitations result from the special relationship with the Federal Government. The end result is that the District has an artificially constricted tax base, as you mentioned, sir, and the overwhelming needs of an inner city.

Excuse me. I get choked up when I talk about taxes.

Senator BROWNBACK. Well, take a sip of water then.

Dr. GANDHI. For the District the juxtaposition of a limited tax base against the responsibilities of multiple jurisdictions produces chronic budgetary distress, ranging annually from $470 million to about $1.1 billion according to the Government Accountability Office (GAO) report in May 2003. Even in the wake of D.C.'s phenomenal fiscal recovery of the past decade—and may I brag a little, Mr. Chairman; it has indeed been a phenomenal recovery. In the mid-1990s when John Hill was our Executive Director of the Control Board, we had roughly $500 plus million in deficits. Today we enjoy about $1.6 billion in surplus in our fund balance, about a $2.1 billion turnaround which is unmatched, unparalleled anywhere in the municipal annals of the history in this country. So this is a truly remarkable achievement on the part of the Control Board, the Congress, of our elected leaders, Mayor and the Council.

Even in the wake of D.C.'s phenomenal fiscal recovery of the past decades, it faces pervasive infrastructure problems, high tax and debt burdens, and the needs of a large number of urban poor, like that found in every city.

The District's economic recovery in the late 1990s was hastened by the Federal wisdom and action, for example the fiscal improvements brought about by the 1997 Revitalization Act. Still, the District now struggles and will continue to struggle with the multi-jurisdictional requirements and a limited urban tax base. There are additional Federal constraints on use of significant parts of the tax base that is there. You just mentioned about how we cannot tax the income tax base here and also the real property base.

Two consequences of this structural imbalance between the District's revenue base and its spending requirements are: one, a high per capital tax burden, with some of the highest tax burdens in the region and the country; and the highest per capita borrowing. D.C.'s tax burden on households is in the upper one-third when compared to the largest cities in the United States. The burden is greater on the business. D.C.'s tax rate on net business income is 9.975 percent. The gross receipts tax on public utilities used by businesses is around 11 percent and the real property tax on commercial property is around $1.85 per $100 value, as compared to a range of 92 cents to about $1.16 in the neighboring suburbs.

The GAO ranks D.C.'s tax burden among the very highest in the country. Indeed, sir, there are only two States in the country that would have a higher tax rate than we do. About 42 States have lower tax rates than we do.

Further, the District's very high per capita borrowing reflects the city's efforts to sustain infrastructure generally provided by multiple jurisdictions. The District's per capita tax-supported debt burden exceeds $8,000, the highest per capita of any major city in the Nation. For a long time, sir, our tax policy has been once we find a taxpayer we never let him go. We keep piling on. And at the same time, either we tax or we borrow to meet our needs.

Challenges may arise, however, adding to D.C.'s structural imbalance in coming years. First, all State and local revenue systems are stressed by the changing nature of the economy as it evolves more into a service-oriented economy.

Turning another page, page 5, sir, the District of Columbia has a large urban population that needs help. Census data for 2004 estimate D.C.'s poverty rate at around 19 percent, the fourth highest in the Nation after Mississippi, Louisiana, and New Mexico. Of D.C.'s 248,000 plus households, 18 percent have incomes less than $15,000. Median household income is about $46,000 in a metropolitan area where median household income is around $71,000. Only about one-third of the District's households are at or above the metropolitan median. Like other cities, the District is accountable for greater efforts to help the less advantaged in the city's population.

Income discrepancy among D.C.'s residents is reflected in the distribution of D.C.'s adjusted gross income, as shown in table 1. The concentration of both income tax burden on a small number of filers is evident. Those filers with adjusted gross income of $75,000 and more take up 17 percent of the filers, have 57 percent of the income, and pay 71 percent of the District's individual income tax. That is quite a remarkable number, Mr. Chairman, if you were to look at the table, that roughly 4 percent of our taxpayers pay 44 percent of our income taxes, 17 percent pay 71 percent of income taxes, and roughly 50 percent pay 93 percent of our income taxes. So roughly the other half simply does not pay.

Filers with more than $200,000 income comprise just 4 percent of all filers, 30 percent of income, and 44 percent of local income tax collections. At the lower income level, about one-half of all filers have $30,000 or less in the adjusted gross income (AGI) income and 16 percent have even $10,000 or less.

Turning to page 7, Mr. Chairman, as you have suggested a Federal flat tax in the District of Columbia, the tax would apply both to individuals on their earned income and to businesses on their gross income net of costs, wages, and investment in plant and equipment. Individuals would be taxed only on personal earnings. Businesses would not be taxed on tangible investment. The flat tax thereby eliminates any potential double taxation of rents, profits and interest and eliminates tax disincentives to investment.

The tax would be calculated at a constant tax rate on taxable income and the rate could be applied either on all income or income above some threshold amount that is tax exempt. There would be no other exemptions or deductions.

Depending on how it is formulated, a Federal flat tax could benefit few, some, or most individual taxpayers living in the District. Under the chairman's proposal, District taxpayers will have the choice of either the flat tax or the current tax depending on which method gives them a more favorable tax liability.

Table 2 illustrates the Federal tax liabilities on current District residents. The table also identifies the District's relatively unusual distribution of taxpayers types. Fifty-five percent of D.C.'s income tax payers are single filers with no dependents, another 22 percent are single individuals with dependents, and 3 percent are dependents with taxable income. This leaves only 20 percent who are filing as married households. This is quite a remarkable number, sir, that only 20 percent of our tax filers are married.

Turning to page 9, single filers have D.C. AGI of about $45,745 and for those with wage and salary income average earned income is around $44,934.

With the first alternative of the flat tax, about $4,000 of personal exemption and 18 percent tax on the remainder, the calculated tax is around $7,368. This amount exceeds current tax both for the itemizers and for those taking standard deductions. The average single person is not most likely to choose this flat tax. The only filer type that most likely prefers this tax is the married two-earner type that has much higher average income at $201,000 and plus. This filer currently pays $35,326 to about $40,000 depending on deductions. The liability drops to about $25,000 with the flat tax at $4,000 per exemption and 18 percent tax rate.

The second alternative flat tax is much less restrictive and would likely be chosen by many filers, including singles with standard deductions and married people with standard deductions as well. This alternative has a more generous $8,000 personal exemption and a lower, 16 percent tax rate. Even with this form, approximately 50,000 D.C. filers who take the Federal earned income tax credit, so-called EITC, are likely to prefer the current tax. This Federal credit can actually refund more than the total tax owed by a working class or low income filer. Under the current tax treatment for the average head of the household, for example, the refund adds about $1,350 for a filer with standard deduction and about $2,170 for a filer with itemized deductions.

The third alternative is a simple compromise of the two previous ones, with a more generous personal exemption at $8,000 and more restrictive tax rate at 18 percent. In this format there is likely to be a greater mixture of those choosing the flat and those choosing the current tax forms.

The final column in table 3 confirms that a filer with no earned income will benefit significantly from a flat tax on individual income. As compared to the current tax, an average single filer taking the standard deduction saves about $6,000 and a married filer with one income about $15,000.

I turn to page 12, sir, in the middle of the page. The first alternative, with $4,000 personal exemption and 18 percent tax rate on earned income, would be selected by approximately 15 percent of D.C.'s current individual income tax filers with earned income, based on our very rough calculations. The second alternative, $8,000 personal exemption and 16 percent tax rate, would be chosen by about 75 percent of current filers with earned income. And the third alternative, with an $8,000 exemption and 18 percent tax rate, would be chosen by roughly 60 percent of current filers with earned incomes. We assume that filers with incomes only from other sources will choose the flat tax alternatives. These approximate ratios are based on our individual income tax filers for 2003 D.C. taxes.

In providing the choice between the flat and the current tax methods, you offer, sir, a significant benefit to the residents of the District. The Federal Government would lose revenue from D.C. taxpayers, at least in the startup years. The amount could be as large as $1 billion in the first year, as roughly approximated by our data. The billion dollar calculation is made by us and is based on

the District's own tax base and Tax Code. It is not to be considered an authoritative number because Federal revenue depends on the Federal code and Federal base and actual first year losses depend on the alternative flat tax that is selected. Scoring of actual losses must come from the Federal sources.

In the later years, the amount of the Federal revenue loss will depend on how much economic activity is stimulated by the voluntary flat tax. Individuals moving to the District in order to take advantage of the flat tax would increase the Federal losses because their total Federal tax liabilities would fall. True economic growth, however, could offset these losses. Some economists argue that businesses will want to locate in the District for tax purposes because their tangible investments would be fully expensed by the flat tax and therefore not subject to Federal taxation. This incentive to invest could then produce economic growth.

I turn to page 14. The District's own tax base could grow under a voluntary Federal tax due to two influences: one, businesses and households that move to the District to get preferred Federal tax status; and two, expansion of the current economic base. Both income and real property tax revenues would grow. This assumes that D.C.'s own tax treatment of households and businesses does not change and the optional Federal flat tax is enacted as a permanent change to the Federal tax law. The District would continue to base tax calculation on the equivalent of current Federal adjusted gross income and would continue to tax all income received by the household and not just earned income.

Turning to the next page, in general we would not expect that franchise tax revenue to the District government would grow at a rate comparable to the growth of local business income. We would expect growth in real property tax revenue, as competition for limited space becomes more fierce. The property values, assessments, and costs inevitably will rise with demand because the District is a small, highly developed jurisdiction with federally mandated height limitations.

I pass over some of the compliance issues and turn to page 16. More important, what impact there would be on our households. A small group of very high income taxpayers, especially with no wage income, fewer than about 1,000 current households, would be major beneficiaries of the flat tax. These taxpayers rely on income from interest earnings, rental activity, and profits and capital gains.

Further, we expect that others with similar sources of income would want to move into the District for the Federal tax benefit. For example, a married two-income filer living elsewhere with $650,000 of gross income currently pays about $185,000 in Federal tax and may pay up to about $40,000 in a local non-D.C. tax jurisdiction. If all the income is from non-wage and salary sources, the filer can save about $185,000 in Federal tax annually by moving to the District. The filer would pay about $60,000 in D.C. income tax, about $20,000 more than previously, thus netting about $165,000 annual tax savings from the move.

If all the filer's income is due to wage earnings and the couple moves to the District, Federal tax could drop to $150,000 under the most restrictive of the flat tax options. D.C. local tax adds back about $20,000, leaving the taxpayer with a net tax reduction of at

least $50,000 annually. Even with the higher cost, some households are likely to find the District a beneficial new location.

Once they move to the District, these new residents would owe the District local income tax. If for example the District adds about 500 households, just about 5 percent, to the number with incomes above $200,000, then individual income tax revenue would increase roughly $30 million annually. Similarly, an addition of about 1,000 more such households might generate $60 million in additional D.C. government revenue.

Of course, it is very difficult to estimate how many may move in or out without analyzing a concrete flat tax proposal. More new residents would mean more revenue and fewer new residents means less increase in revenue. While the District could not close the structural imbalance with these new residents alone, the net fiscal contribution to the District would be beneficial.

Non-wage income is not limited to the very wealthy. Other middle class to upper income households might want to move here to shelter retirement savings and other investment income from Federal tax. Much as Florida is a haven from State income taxes in retirement, the District would be a partial haven from the Federal income taxes for retirees. Households attracted in this way are likely to have a net fiscal benefit for the District's budget.

Because of this tax incentive, a voluntary Federal flat tax could add to housing price pressures in the District. While positive occurrences for budgetary purposes, this is a serious problem for other reasons related to the loss of urban middle class. For more than 50 years, the population of the District has been falling. Within the smaller total population, the District has more people at the lower end of the income distribution, far fewer in the middle class, and a declining upper income population. In recent years the number of households in the District is growing again, but not the population. Many of these new households are high income, a nearly necessary condition in a city where housing prices grew an average 15 percent annually over the last 5 years and roughly doubled in that period. With only 2 percent increase in the households overall, the number of households with at least $100,000 or more in income grew by 27 percent in the time period of 2000–2004. Population has not grown because, as a generalization, the filers moving in are single or sometimes couples, while the filers moving out are more likely to have children.

We do not know how much the voluntary tax would add to price pressure for the housing. Because a flat tax neutralizes the favorable tax treatment of itemizers—most of these are home buyers—additional housing price pressure can be dampened. Compared to the current tax system, a person electing to use the flat tax would not be able to deduct either mortgage interest or real property taxes from taxable income, thereby limiting the boost of a potential offer price for housing.

However, if theorists are right and if business demand rises for the D.C. location under a flat tax, then commercial users will bid up the prices, shifting the property markets somewhere or somewhat away from residential land uses and further increasing housing prices.

However, the similarity between our estimated $1 billion possible initial revenue loss at the Federal level and the magnitude of the District's structural imbalance of about $1 billion is striking. Clearly, the benefits of reduced Federal taxation will accrue to the citizen and business taxpayers while the structural imbalance is a problem of local government.

Still, thoughtful policy management could find a way to narrow the local budgetary problem as a result of this windfall. It is, after all, much like a negotiated middle between the current Federal tax policy for the District and the current Federal treatment allowed Puerto Rico, where there is no Federal tax on local earnings. In Puerto Rico the state government receives the revenue from taxation to the local earnings.

Mr. Chairman, I thank you for holding this hearing and providing this forum. The possibility of a new, deeper and better Federal-city relationship is very exciting. I look forward to any questions you may have. This concludes my oral comments. I would appreciate kindly putting my full testimony in the record. Thank you, sir.

Senator BROWNBACK. Your full testimony will be put into the record.

[The statement follows:]

PREPARED STATEMENT OF NATWAR M. GANDHI

Good afternoon Mr. Chairman and members of the Senate Appropriations Committee on the District of Columbia. I am Natwar M. Gandhi, Chief Financial Officer of the District of Columbia. I am here to testify on the matter of the fiscal relationship between the Federal government and the District of Columbia and, to discuss your idea for a voluntary Federal flat tax for the District's businesses and households.

A voluntary Federal flat tax may add to the desirability of D.C. as a place to live and to work. However, it will also give rise to additional challenges within the District as more activities compete for the limited amount of available space.

In this testimony I will speak in general terms about the concept of a voluntary Federal flat-tax in the District. If a legislative plan is presented by the Congress for implementing a flat tax in the District, I will work with the Congress to provide analysis of the plan. Consistent with my role as the District's independent Chief Financial Officer, my testimony will only address the fiscal and economic impact of the flat tax. My testimony does not discuss the political or social policy aspects of a flat tax, since that role is reserved for the elected officials of the District.

Unique relationship

The District of Columbia is home to the Government of the United States of America. D.C. enjoys national galleries, monuments and parks that are the envy of the world and that attract tourists and business travelers. These travelers and the government that draws them create the economic and fiscal bases of the city.

The Federal-city relationship is complex and not without problems, particularly fiscal problems. The words are well-worn—D.C. has the jurisdictional responsibilities of a city, county, state, and school district while it has only the tax base of a core city. There is a mutually beneficial relationship between the District and the Federal government stemming from the District's position as the home of the Federal government. At the same time D.C.'s complex jurisdictional responsibilities and limitations result from this special relationship with the Federal government. The end result is that the District has an artificially constricted tax base and the overwhelming needs of an inner city.

For D.C., the juxtaposition of a limited tax base against the responsibilities of multiple jurisdictions produces chronic budgetary distress—ranging from $470 million to $1.1 billion, according to the GAO in their May 2003 report. Even in the wake of D.C.'s phenomenal economic and fiscal recovery of the past decade, the District faces pervasive infrastructure problems, high tax burdens, and the needs of a large number of urban poor (like that found in every city).

The District's economic recovery in the late 1990s was hastened by Federal wisdom and action—for example in the fiscal improvements brought by the 1997 Revitalization Act. Still, the District now struggles, and will continue to struggle, with multi-jurisdictional requirements on a limited urban tax base. And, there are additional Federal constraints on use of significant parts of the base that is there. For example, approximately two-thirds of the income tax-base and more than one-quarter of the real property tax-base are exempt from local tax due to Federal restrictions.

Two consequences of this structural imbalance between the District's revenue base and its spending requirements are: (1) a high per capita tax burden with some of the highest tax burdens in the region and the country; and (2) the highest per capita borrowing. D.C.'s tax burden on households ranks in the upper one-third when compared to the largest city in each state (for total state and local burden of sales, income, property, and automobiles).

The burden is greater on businesses. D.C.'s tax rate on net business income is 9.975 percent; the gross receipts tax on public utilities used by businesses is 11 percent; purchases of intermediate products used by D.C. businesses are subject to the general retail tax; and the real property tax on commercial property is $1.85 per $100 of value as compared to a range of $0.92 to $1.16 in neighboring suburbs.

The GAO ranks D.C.'s tax burden among the very highest in the country. "The District's tax burden (actual revenue collected from local resources relative to their own-source revenue capacity) is among the highest of all fiscal systems, . . . The District's actual tax burden exceeded that of the average state fiscal system by 33 percent, based on our lower estimate of its own-source revenue capacity, and by 18 percent, based on our higher estimate of that capacity." [1]

The District's very high per capita borrowing reflects the city's effort to sustain infrastructure generally provided by multiple jurisdictions. At $6,598 per capita, the D.C. debt burden exceeds the combined state and local burden in New York City by $813—or 14 percent. The District burden exceeds that of other cities by even larger margins.

Challenges may arise, however, adding to D.C.'s structural imbalance in coming years. First, all state and local revenue systems are stressed by the changing nature of the economy, as it evolves more into a service oriented economy. Because state and local tax systems were developed around the manufacturing and sale of goods, the old ways of gathering tax revenue are increasingly inadequate to the newer economy. The revenue challenge is made even greater in the District by the Federal prohibitions against taxing incomes earned by non-residents workers and incomes earned by certain professional services.

Second, the District has a large urban population that needs help. Census data for 2004 estimate the D.C. poverty rate at about 19 percent, the fourth highest in the nation when compared to states, after Mississippi, Louisiana, and New Mexico. Of D.C.'s 248,563 households, 18 percent have income of less than $15,000.[2] Median household income is about $46,600—in a metropolitan area where median household income of $70,900. Only about a third of D.C.'s households are at or above the metropolitan median. Like other cities, D.C. is accountable for greater efforts to help the less advantaged in the city's population. The fiscal year 2007 budget, recently submitted by the Mayor to the Council, works hard to manage the expenditure needs and fiscal requirements of D.C.'s lower income population.

Income discrepancy among D.C. residents is reflected in the distribution of D.C. Adjusted Gross Income as shown in Table 1. The concentration of both income and tax burden on a small number of filers is evident—those filers with adjusted gross income of $75,000 and more make up 17 percent of filers, have 57 percent of the income, and pay 71 percent of the District's individual income tax. Filers with more than $200,000 in gross income comprise just 4 percent of all filers, 30 percent of income, and 44 percent of local income tax collections. At the lower income levels, about one-half of all filers have $30,000 or less DCAGI—16 percent have $10,000 or below.

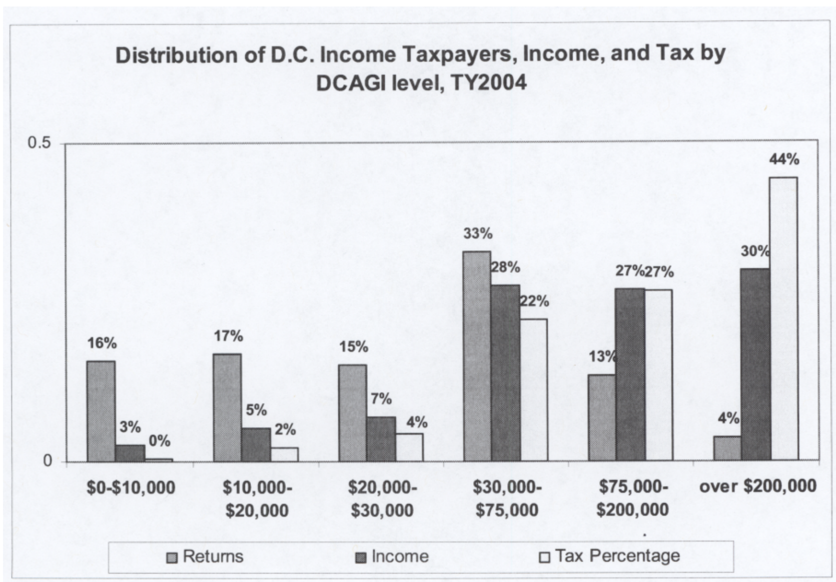
[1] GAO–03–666, District of Columbia, Structural Imbalance and Management Issues, May 2003, page 41.

[2] American Community Survey, 2004.

TABLE 1.—TY2004 INDIVIDUAL INCOME TAX FILERS, D.C., BY D.C. ADJUSTED GROSS INCOME CATEGORY, FROM FORM D–40

		DCAGI—					
		$0–$10K	$10–$20K	$20–$30K	$30K–$75K	$75K–$200K	Over $200K
Number Returns	262,328	41,368	43,718	39,596	85,971	35,041	9,821
Returns (percent)	100	16	17	15	33	13	4
Income (percent)	99	3	5	7	28	27	30
Tax Amount (millions)	$1,037	$4	$22	$44	$229	$277	$459
Tax Percentage	100	....	2	4	22	27	44
EITC Returns (percent)	99	33	33	28	5	....	....

Note: 6,813 filers have DCAGI of less than or $0. These are not included here.



Voluntary Federal Flat Tax

The Chairman has suggested a Federal flat tax in the District of Columbia. The tax would apply both to individuals—on their earned incomes—and to businesses on their gross income net of costs, wages, and investment in plant and equipment. Individuals would be taxed only on personal earnings. Businesses would not be taxed on tangible investment. The flat tax thereby eliminates any potential double taxation of rents, profits, and interest and eliminates tax disincentives to investment. (Because unearned incomes are partly held in tax exempt portfolios, not all are currently double-taxed.) The tax would be calculated at a constant tax rate on taxable income and the rate could be applied either on all income or on income above some threshold amount that is tax exempt. There would be no other exemptions or deductions.

Taxation of Individuals.—Depending on how it is formulated, a Federal flat tax could benefit few, some, or most individual income taxpayers living in the District. Under the Chairman's proposal, District taxpayers will have the choice of either the flat tax or the current tax, depending on which method gives them a more favorable tax liability.

Table 2 illustrates the Federal tax liabilities on current residents, based on filer groups and average income of the filer groups. The table also identifies the District's relatively unusual distribution of taxpayer-types. Fifty-five percent of D.C. income taxpayers are single filers with no dependents, another 22 percent are single individuals with dependents, and 3 percent are dependents with taxable income. This

leaves 20 percent who are filing as part of a married household.[3] The incomes reported in Table 2 are the average D.C. Adjusted Gross Income (DCAGI) for the filer group in TY2004.

[3] The corresponding Federal distribution of filers for TY2003 is 45 percent married, 13 percent head of household, and 42 percent single (including dependents).

TABLE 2.—CURRENT TAX ON FEDERAL INCOME TAX FILERS FILING FROM A D.C. ADDRESS, BY FILER TYPE AND BY AVERAGE INCOME, TY2004

	Number of Filers	Percent of Total Filers	Type of Filer	Est Average Income, by Filer Group	Ave Deduction, by Filer Group	Exemption	Current Federal Tax Liability
TOTAL	262,328	100					
SINGLE	145,433	55	Standard deduction	$45,745	$3,370	1	$6,046
			Itemized deduction	45,745	12,920	1	4,079
HEAD OF HOUSEHOLD [1]	57,197	22	Standard deduction	30,891	7,300	3	(1,350)
			Itemized deduction	30,891	13,756	3	(2,171)
MARRIED FILING JOINT (1 INCOME)	27,829	11	Standard deduction	116,802	10,000	4	15,186
			Itemized deduction	116,802	27,975	4	10,686
MARRIED FILING JOINT (2 INCOMES)	14,825	6	Standard deduction	201,060	10,000	3	40,540
			Itemized deduction	201,060	30,274	3	35,326
MARRIED FILING SEPARATELY	8,003	3	Standard deduction	58,631	5,000	2	9,271
			Itemized deduction	58,631	17,039	2	6,259
DEPENDENT FILER	7,799	3	Standard deduction	6,952	5,000		196
			Itemized deduction	6,952	5,000		196

[1] The mean head-of-household filer is eligible for the Refundable Earned Income Tax Credit. Without EITC, the filer would pay $0 tax.

Data Source: Calculations based on DC Form D–40.

Table 3 identifies the impact of various formats of a Federal flat tax on D.C. resident filers. To do this, the table first identifies how much wage and salary "earned" income a filer has—and also notes that some filers have no such income and, instead, rely on other types of income such as dividends, interest, and profit. This is critical because current taxpayers with no "earned" incomes pay no individual income tax under the flat tax. Overall, about 86 percent of D.C. filers have earned income; the other 14 percent (adjusted for those with earned income deferred from a prior year for current use) would have zero liability and most likely prefer a flat tax.

Single filers have average DCAGI of $45,745 and, for those with wage and salary income, average earned income of $44,934. With the first alternative of the flat tax—a $4,000 personal exemption and 18 percent tax on the remainder, the calculated tax is $7,368. This amount exceeds current tax both for itemizers (at $4,079) and for those taking the standard deduction (at $6,046). The average single person is not most likely to choose this flat tax. The only filer type that prefers this tax is the married, 2-earner type that has much higher average income at $201,060 and $155,537 from combined wages and salaries. This filer currently pays $35,326 or $40,540, depending on deductions; the liability drops to $25,837 with the flat tax at $4,000 per exemption and 18 percent tax rate.

The second alternative flat tax is much less restrictive and would likely be chosen by many filers, including—at average incomes—singles with standard deductions and married people with standard deductions, as well as married two income filers with itemized deductions. This alternative has a more generous $8,000 personal exemption and a lower 16 percent tax rate. Even with this form, the approximately 50,000 D.C. filers who take the Federal Earned Income Tax Credit (EITC) are likely to prefer the current tax. This Federal credit can actually refund more than the total tax owed by a working, low-income filer. Under current tax treatment for the average head of household, for example, the refund adds $1,350 for a filer with standard deductions and $2,171 for a filer with itemized deductions.

The third alternative of a Federal flat tax in Table 3 is a simple compromise of the two previous, with the more generous personal exemption at $8,000 and the more restrictive tax rate at 18 percent. In this format there is likely to be a greater mixture of those choosing the flat and those choosing the current tax forms.

The final column of Table 3 confirms that a filer with no earned incomes will benefit significantly from a flat tax on individual income. As compared to the current tax, an average single filer taking the standard deduction saves $6,046; a married filer with one income saves $15,186.

TABLE 3.—CURRENT TAX AND FLAT TAX OPTIONS ON D.C. FEDERAL INCOME TAX FILERS, BY FILER TYPE AND BY AVERAGE INCOME, TY2004

	Number of Filers	Number Wage & Salary Filers	Percent of Total Filers	Type of Filer	Est Average Income, by Filer Group	Average W&S Income for W&S Filers	Exemptions	Current Federal Tax	Flat Tax Liability at $4,000 & 18 Percent Wage & Salary Filer [1]	Flat Tax Liability at $8,000 & 16 Percent Wage & Salary Filer [1]	Flat Tax Liability at $8,000 & 18 Percent Wage & Salary Filer [1]	Any Flat Tax Non-W&S Filer
TOTAL	262,328	224,684	86	....	....	....	....	....	....	....	....	....
SINGLE	145,433	122,958	85	Standard	$45,745	$44,934	1	$6,046	$7,368	$5,909	$6,648	....
				Itemized	45,745	44,934	1	4,079	7,368	5,909	6,648	....
HEAD OF HOUSEHOLD [2]	57,197	53,619	94	Standard	30,891	30,531	3	(1,350)	3,336	1,045	1,176	....
				Itemized	30,891	30,531	3	(2,171)	3,336	1,045	1,176	....
MARRIED FILING JOINT (1 INCOME)	27,829	22,804	82	Standard	116,802	107,594	4	15,186	16,487	12,095	13,607	....
				Itemized	116,802	107,594	4	10,686	16,487	12,095	13,607	....
MARRIED FILING JOINT (2 INCOMES)	14,825	12,589	85	Standard	201,060	155,537	3	40,540	25,837	21,046	23,677	....
				Itemized	201,060	155,537	3	35,326	25,837	21,046	23,677	....
MARRIED FILING SEPARATELY	8,003	6,478	81	Standard	58,631	59,600	2	9,271	9,288	6,976	7,848	....
				Itemized	58,631	59,600	2	6,259	9,288	6,976	7,848	....
DEPENDENT FILER	7,799	6,232	80	Standard	6,952	7,245	....	196	1,304	1,159	1,304	....
				Itemized	6,952	7,245	....	196	1,304	1,159	1,304	....

[1] Shows preference for Flat Tax Option.
[2] The average head-of-household filer is eligible for the refundable Earned Income Tax Credit. Without EITC, the filer would pay $0 tax.

Data Source: Calculations based on DC Form D–40.

Filers who have no incomes from wages, salaries, or other earned income sources will pay no tax under a flat tax. This explains the blank column under "no-wage filer" for each flat tax option.

Renters and those who choose standard deductions on the current tax are more likely to benefit from a flat tax than many homebuyers and others who itemize (because their Federal tax burden is not eased by deductible expenditure on mortgage interest, real property tax, and other itemized deductions). While itemizers also may benefit from flat taxation, the magnitude of the benefit is likely to be smaller simply because itemizers already benefit from some tax breaks.

Individuals with incomes from rents, interest, capital gains, and other unearned sources will gain from a flat tax; these incomes will no longer be taxed under the individual income tax. They will be taxed only as part of the income of the business that generates them.

Voluntary Flat Tax.—In providing the choice between flat and current tax methods, the Chairman offers a significant benefit to residents of the District. The Federal government will lose revenue from D.C. taxpayers at least in the start-up years—the amount could be $1 billion in the first year, as roughly approximated based on D.C.'s data.[4]

In later years, the amount of Federal revenue loss will depend on how much economic activity is stimulated by the voluntary flat tax. Individuals moving to D.C. in order to take advantage of the flat tax would increase Federal losses—because their total Federal tax liabilities would fall. True economic growth, however, could offset these losses. Some economists argue that businesses will want to locate in D.C. for tax purposes because their tangible investments would be fully expensed by the flat tax and therefore not subject to Federal taxation. This incentive to invest could then produce economic growth.

The incentive is partly offset by transition costs to businesses that would lose depreciation benefits under a flat tax. The voluntary aspect of the proposal is, effectively, a transition plan, allowing current assets to be depreciated before electing the flat tax. An explicit transition plan would directly address assets currently being depreciated. A critical component of the transition plan is to identify how often a taxpayer can choose between flat and current treatments: is it annually, only once for all time, or some intermediate number of choices? Taxpayer behavior will be affected by this component. Also, taxpayers generally prefer that tax policy be predictable, allowing them to plan in terms of it. Any flat tax proposal should be offered as permanent, not temporary or experimental, if taxpayers are going to adjust their basic behavior around the policy change.

Impact on the District's Revenues

The District's own tax base could grow under a voluntary Federal flat tax, due to two influences: (1) businesses and households that move to District to get preferred Federal tax status and (2) expansion of the current economic base. Both income and real property tax revenues would grow. This assumes that D.C.'s own tax treatment of households and businesses does not change and that the optional federal flat tax is enacted as a permanent change to federal tax law (a perception that it is temporary would substantially reduce these effects). D.C. would continue to base tax calculations on the equivalent of current Federal Adjusted Gross Income and would continue to tax all incomes received by households, not just earned income.

The fiscal impact on D.C. from the flat tax on business income is difficult to assess. For D.C., the revenue gains from adding more incorporated and unincorporated businesses would depend on the ability of new businesses to shelter income from local taxation. In D.C., about 70 percent of business tax filers pay only the local minimum tax of $100 annually. Partnerships and proprietorships with 80 percent or more of their income due to services of the owners do not even file locally. The issues in taxing business income are known well across state and local jurisdictions and income tax sheltering is a complex art.

In general, we would not expect that franchise tax revenue to the District government would grow at a rate comparable to the growth of local business income. This assumes that D.C.'s tax policy for business income does not change and that D.C. decouples from the Federal change in definition of taxable income. If instead D.C. were to adopt the proposed Federal treatment of expensing investment outlays, then local revenue would decline.

[4] The $1 billion is a calculation made by the OCFO of the District and based on the District's own tax base and tax code. It is not to be considered authoritative because the Federal revenue depends on the Federal code and Federal base. Determination of actual losses must come from Federal sources.

We would expect growth in real property tax revenue as competition for limited space becomes more fierce. Property values, assessments, and costs inevitably will rise with demand because the District is a small, highly developed jurisdiction with federally mandated height limitations.

Tax Administration and Compliance.—A voluntary flat tax will complicate tax compliance for District residents as well as tax administration at both the Federal and local level. With a voluntary flat tax, a District taxpayer will have to compute the tax both ways prior to deciding which option is best for his or her situation. Assuming that the District decouples from the Federal flat tax, a District taxpayer who chooses the flat tax will have to maintain separate records of information that currently is copied from Federal tax forms, in order to comply with the D.C. tax system. At the Federal level, the Internal Revenue Service (IRS) would have the added burden of auditing residency, as the voluntary flat tax will create new tax sheltering opportunities based on where a taxpayer lives. At the local level, the D.C. tax administration would lose the benefit from IRS audit and enforcement activities.

Impact on Households.—A small group of very high-income taxpayers, especially those with no wage income (fewer than 1,000 current households), will be major beneficiaries of the flat tax.[5] These taxpayers rely on income from interest earnings, rental activity, and profits and capital gains. Further we expect that others with similar sources of income would want to move into the District for the Federal tax benefit.

For example, a married, 2-income filer living elsewhere, with $650,000 gross income, currently pays about $185,000 in Federal tax and may pay $40,000 in local (non-D.C.) tax. If all of the income is from non-wage-and-salary sources, the filer can save $185,000 in Federal tax annually by moving to D.C. The filer would pay about $60,000 in D.C. income tax, about $20,000 more than previously, thus netting $165,000 annual tax savings from the move. If all the filer's income is due to wage earnings and the couple moves to D.C., Federal tax could drop to $115,000 under the most restrictive of the flat tax options. D.C. local tax adds back $20,000—leaving the taxpayer with a net tax reduction of at least $50,000 annually. Even with higher costs in D.C., some households are likely to find D.C. a beneficial new location.

Once they move to the District, these new residents would owe the District's local income tax. If, for example, D.C. added about 500 households, or about 5 percent, to the number with incomes over $200,000, then individual income tax revenue would increase roughly $30 million annually. Similarly, an addition of 1,000 more such households might generate $60 million of additional D.C. government revenue. Of course, it is very difficult to estimate how many may move in or out without analyzing a concrete flat tax proposal. More new residents would mean more revenue and fewer new residents mean less increase in revenue. While D.C. could not close the structural imbalance with these new residents alone, their net fiscal contribution to D.C. would be beneficial.

Non-wage income is not limited to the very wealthy; other middle to upper-income households might want to move here to shelter retirement savings and other investment income from Federal tax. Much as Florida is a haven from state income taxes in retirement, D.C. could be a partial haven from Federal income taxes for retirees. (Pension income could continue to be taxed under the flat tax.) Households attracted in this way are likely to have net fiscal benefit for the District's budget.

Because of this tax incentive, a voluntary Federal flat tax could add to housing price pressures in D.C. While a positive occurrence for budgetary purposes, this is a serious problem for other reasons related to the loss of the urban middle-class. For more than 50 years the population of the District has been falling. Within the smaller total population, D.C. has more people at the lower end of the income distribution, far fewer in the middle class, and a declining upper-income population. A recent study by the Brookings Institution documents this change for the period 1979–1999. The data separate households into national quintiles (the top 20 percent, next 20 percent, and so forth) and then locate households from 100 cities, including D.C., within those groups. When compared to 1979, the number of D.C. households in the middle quintile in 1999 is down by nearly 14 percent and, in fact, declined in all but the lowest quintile group. The number of D.C. households in the lowest national quintile group increased 14 percent in the 20 year period.[6]

---

[5] In the District 86 percent of filers have wage or salary income and an unknown number of others take deferred earnings as part of current year income. This is subject to a flat tax. Of those filers with incomes of $500,000 or more, only two-thirds have wage or salary income.

[6] A recent study of the 100 largest cities finds that "in just a handful of divided cities (7), including Washington, D.C., does the number of households at the extremes of the (income) dis-

Continued

D.C. has lost middle-class population in a very pronounced way. This decline is closely entwined with the loss of school-age population as families have moved out; the rise in property values as higher-income singles and couples have moved in; and the decrease in upward mobility because poorer people have fewer housing options as they work and improve their earnings capacity. Indeed, much of the out-migration is known to be of middle-income families looking for better housing and schooling opportunities.

In recent years, the number of households in D.C. is growing again, but not the population. Many of these new households are higher income—a nearly necessary condition in a city where housing prices grew an average of 15 percent percent annually over the last 5 years and roughly doubled in the period. With only a 2 percent increase in households overall, the number of households with at least $100,000 income grew by 27 percent in 2000–2004.[7] Population has not grown because, as a generalization, the filers moving-in are single, or sometimes couples, while the filers moving-out are more likely to have children.

D.C. is a core city and, like other core cities, the home of a disproportionate share of the region's poor, both those permanently poor and those working upward out of poverty. Housing prices that "squeeze out" the middle-class pose serious obstacles for lower-income earners. Without access to potentially better housing, they also have less access to better transportation, perhaps to safer neighborhoods and higher performing schools. The whole promise of upward mobility is damaged—except for those who leave.

We believe that the Federal flat tax for D.C. would add to housing price pressures in the District. Given the recent demand for housing, especially among higher-income homeowners, it is hard to describe how much more dramatic the impact might be.

We do not know how much the voluntary flat tax would add to price pressure. Because a flat tax neutralizes the favorable tax treatment of itemizers—most of these are homebuyers—additional housing price pressure is dampened. Compared to the current tax system, a person electing to use the flat tax would not be able to deduct either mortgage interest or real property taxes from taxable income, thereby limiting the boost to a potential offer-price for housing. However, if theorists are right and business demand rises for D.C. locations under a flat tax, then commercial users will bid up prices, shifting the property market somewhat away from residential land uses and further increasing housing prices.

A New-View of the Federal/city relationship.—The similarity between the $1 billion possible initial revenue loss at the Federal level and the magnitude of D.C.'s structural imbalance of about $1 billion is striking. Clearly the benefits of reduced Federal taxation will accrue to citizen and business taxpayers while the structural imbalance is a problem of local government. Still, thoughtful policy management could find a way to narrow the local budgetary problem as a result of this windfall. It is, after all, much like a negotiated middle between current Federal tax policy for D.C. and current Federal treatment allowed Puerto Rico where there is no Federal tax on local earnings. In Puerto Rico the state government receives the revenue from taxation of local earnings.

Mr. Chairman, I thank you for holding this hearing and providing this forum. The possibility of a new, deeper, and better Federal/city relationship is very exciting. I look forward to any questions.

Senator BROWNBACK. Thank you very much, Dr. Gandhi. That was very interesting and very thorough. I want to ask some questions about that afterwards.

Mr. Golden, Chairman of the Federal City Council, thank you for joining us.

---

tribution exceed that in the middle." The study finds the following for D.C., based on the U.S. Census of 1979 and 1999. Income groups are determined based on national quintiles.

# Households	*Low Income*	*Lower-Middle*	*Middle*	*Upper-Middle*	*High*
1979	57,837	53,611	50,019	40,141	53,897
1999	66,094	51,759	43,157	38,505	49,076
Change	+14%	–3%	–14%	–4%	–9%

Source: Alan Berube and Thacher Tiffany, "The Shape of the Curve: Household Income Distributions in U.S. Cities, 1979–1999, The Brookings Institution, August 2004.

[7] American Communities Survey, U.S. Census, 2000 and 2004.

STATEMENT OF TERENCE C. GOLDEN, CHAIRMAN, FEDERAL CITY COUNCIL

ACCOMPANIED BY JOHN HILL, CHIEF EXECUTIVE OFFICER, FEDERAL CITY COUNCIL

Mr. GOLDEN. Thank you, Mr. Chairman, for allowing me to be here. I have to say I really appreciate the opportunity to speak to you and also to be on this board and panel that you are visiting with today. I think you have three of the strongest financial minds in our city to talk to you: obviously, Julia and Dr. Gandhi, who I think has been tremendous for our city over the long term; John Hill, who is now our Chief Executive Officer and was the head, the Executive Director of the Federal Financial Board that oversaw our improvement, really has a good grip on what's happening. So I am proud to be with them.

Before I begin, I would like to first submit my record—my written statement for the record.

Senator BROWNBACK. It will be in the record.

Mr. GOLDEN. Thank you so much.

I would like to begin by saying thank you to you, chairman, for all you have done for our city. The record of your committee in providing us with support through a lot of difficult challenges is greatly appreciated. I also want to thank you for your recognition of the challenges that are facing the District of Columbia. I cannot tell you how many times I have appeared and a number of us have appeared before groups similar to this without a real understanding of what pressures we face as the District of Columbia that are unique because we are the Nation's Capital.

I also want to acknowledge the efforts that you have made on this flat tax. It represents a significant step forward and something that has the potential of making a real difference in the District of Columbia. So we really do appreciate what you have done and where you are headed overall.

Dr. Gandhi talked about all the unique relationships of the District of Columbia and its special place in our country, and also the situation that occurs as a result of that. From my point of view, simply there are really two major issues that cause the business community and cause all of the taxpayers real concern. First of all, we do a lot of wonderful things for the Federal Government, for our leaders that come in and work here in the city, and for the 20 million individuals who visit our Nation's Capital. But clearly the bottom line is that the cost of doing this and running this city is very expensive. Our budget, both the Federal and District component, is $7.5 billion a year. Imagine that for 570,000 residents, and when you begin to parse that out and look at who are actually paying taxes, as opposed to receiving benefits, it is an even greater struggle. So I think you are right on target in understanding some of the challenges that we face.

I think all of us as businessmen are also very much concerned about the future outlook. Clearly we have had a great run in time, but we have also had some tremendous capital expenditures that we need to deal with in the future. Unfortunately, when the District became—responsibility for the District was transferred to its residents, what was also transferred to us was the burden of an in-

frastructure that was old, obsolete, and in tremendous need of repair.

Today we start this year with a bond debt of about $4.4 billion, which is roughly $7,000 per capita, which is the highest in the Nation. So we are already beginning with some tremendous challenges.

When we look at the outlook of what we have got to deal with this infrastructure, things get even worse for us. The number one priority for us and I think for you and for the Congress and the Federal Government is we need to get a crime lab and a lab that deals with biohazards and all those things that are important. Clearly, we are the first responder in our city. We have an obligation to be prepared. The cost, however, for the residents of the District of Columbia for this crime lab is $200 million.

We had—when the schools were transferred to the District, the average age of our schools I think was something like 63 years old. Today we have looked and budgeted what the modernization of those schools is and it is over $2 billion.

Our libraries also, which were in a state of disrepair, are going to cost us $250 million to improve. Our budget for roads and bridges is extraordinary. Just as a small indicator, we have over 300 bridges to maintain here in the District of Columbia.

So what I am saying is our capital costs, we are already the highest per capita in the country in terms of capital obligations, and we have got the outlook of having another $4 billion facing us over the next 10 to 12 years. So we are concerned. Clearly, as you have identified and as Dr. Gandhi has identified, we have severe limitations on our ability to tax and that has certainly had an impact overall.

I think that when you look at this tax burden you cannot help but question the fact that over the last 3 years our population has gone from close to 800,000 down to some 570,000 today. I would represent that the taxes and the tax burdens themselves have a direct impact on that. Most of the people that have left are middle class taxpayers and that is both African-American and white.

So just to begin with let me say, do we need to do something? I think that we absolutely do. Senator Brownback, we believe that your flat tax does begin to address the District's financial needs. Until we have something, some specific legislation to look at, it is hard for us to respond in detail or make a final recommendation, and I think Dr. Gandhi's presentation of alternatives will take a week to go through and decipher exactly what begins to make sense and the like.

But I would say, in the mean time we really can offer some general observations. First of all, let me say that we believe that anything that makes the District more attractive to live and work in and which increases its tax base is worthy of consideration. The fact that the proposed approach is optional is good. It allows low income taxpayers to continue to take advantage of the earned income tax credit and the other deductions that are available. So I think you have addressed some of the issues that a lot of people have raised.

It is clear to all of us that under the flat tax the District would benefit financially. More people would move into the city, our Dis-

trict tax base would increase. The lower the flat tax is, the greater would be the impact overall. I think all of us are having a hard time with estimating exactly how many people would move in and we would have to do some careful analysis with that once the legislation got fleshed out. But we certainly see that the impact would be great.

I think when we look at the legislation itself a host of issues need to be considered in evaluating the overall impact of the flat tax legislation. I think for existing and potential District taxpayers, I think they will be interested in knowing, one, the size of the personal exemption, whether mortgage interest payments are to be treated as deductions, the treatment of charitable deductions, and the level at which taxpayers begin to receive benefit from the flat tax.

The real question is is the flat tax fair to all of our taxpayers. From the Federal Government's point of view, I think the issue is is the District-oriented flat tax good for the United States and good tax policy? Is the benefit to the District worth the Federal costs of the program or are there better alternatives for addressing the District's needs?

I think from our point of view as the business community, we also want to take a careful look at this legislation for more than just its financial impact. Our relationship with the District and our attitudes have certainly changed over the last 20, 30 years. The District community is committed to diversity within the District. We want to make sure that the new tax legislation does not have the unintended consequences of displacing the District's low and middle income residents. Clearly, the whole issue of gentrification is an issue in our city and I think, as with all major cities, the cost of living in the city and the cost of housing in the city is running the risk of displacing our low and moderate income residents.

In conclusion, Senator Brownback, let me applaud you for your efforts to get District residents—to propose this legislation. We appreciate your desire to hear from us and other District residents. We also appreciate your desire to hear from our elected leadership. We would like to ask you as you prepare this legislation if we could not participate and if you could not work with the Mayor and our delegate and the District Council to see what we can do together.

Most importantly, I guess in summation, I want to thank you again for your efforts on our behalf. We do have some major issues. We recognize that you understand them and we would like to work with you to see what we can do to make a better District and one that is worthy of being our Nation's Capital. Thank you very much.

[The statement follows:]

PREPARED STATEMENT OF TERENCE C. GOLDEN

Good afternoon, Mr. Chairman, and members of the Committee. My name is Terry Golden and I am appearing before you today in my capacity as Chairman of the Federal City Council. With me is John Hill, who is the Council's Chief Executive Officer. As you may know, the Federal City Council is a nonprofit, non-partisan, business supported civic organization dedicated to the improvement of the Nation's Capital. Founded in 1954, the Council's membership includes 200 of the top business, professional, educational, and civic leaders in the Washington metropolitan area.

You have invited us to testify today on the possible effects of creating an optional flat Federal income tax for District of Columbia residents. We recognize that no spe-

cific legislation has been introduced and that a host of issues remain to be decided, such as the size of the personal exemption and whether deductions would be retained for charitable donations or mortgage interest payments. In view of the foregoing, we believe that it is difficult to say precisely what the effects of a flat tax in the District would be.

However, in addressing the issue, we think a good place to begin is with a brief review of several key facts. First, as Senator Brownback has frequently acknowledged, the District of Columbia is unique in our country in that it has the governmental responsibilities of a city, a county, and a state. Among the costs that the District must bear with its own revenue are the costs of developing and maintaining a physical and human infrastructure (e.g. roads and bridges, mass transit, police, fire, and other first responders) that serves not only the City's 570,000 residents but the half million daily commuters who work in the District and the 20 million annual visitors to the Nation's Capital. While being the Nation's Capital confers many advantages on the District, one disadvantage of Washington, D.C. being the seat of the Federal government is that more than 40 percent of all District property is not subject to local property taxes because it is owned by the Federal government, foreign governments, or international organizations. Also, the District is uniquely disadvantaged in that Congress has explicitly prohibited it from taxing at the source the income of persons who work in the District but reside elsewhere. The net effect of this prohibition is that 70 percent of all income earned in the District cannot be taxed by the District to support District municipal services.

Senator Brownback, as you pointed out in your opening statement at this Subcommittee's hearing on March 8th, the cumulative effect of these Federal restrictions on the District's tax base has led City leaders to impose on District residents and businesses a very high tax burden. As you also noted, this high tax burden undoubtedly is one reason why the City's population has declined over the past several decades while the neighboring jurisdictions have gained population.

We believe that as a general proposition, anything that makes the District a more attractive place to live and work and that enables the District to grow its tax base is worthy of consideration.

As we understand your thinking, your proposal would give District residents the option of continuing to pay their taxes under the current Federal tax system or they could opt for the flat tax. Permitting residents to choose is especially important in this City as many of our low income residents avail themselves of the Earned Income Tax Credit and we wouldn't want to see them barred from doing so.

Under a flat tax, the District would benefit financially and more people, including a number of people of substantial net worth, would likely move into the City. We believe that the prospect of substantially lower Federal taxes unquestionably would be an incentive to move into the District. How many people would do so, however, is anybody's guess. It's worth noting that today, in the absence of a flat tax, the District is experiencing unprecedented growth in its housing stock and is attracting a substantial number of upper income households.

One concern that has been expressed about a flat tax is that it could lead to more displacement as wealthier households displace lower income residents from established neighborhoods. The District's business community is committed to the strength of a diverse community and to the idea that the District should be a community in which all are welcome, irrespective of income, race, ethnicity, or household composition. We believe that the issue of displacement is complex and that there are a host of variables that influence where people choose to live. Should you decide to develop legislation, we would urge you to give this matter the serious attention it deserves and, more generally, we would urge you to work with the District's elected officials if you decide to put forward specific legislation.

Finally, we believe that the aggregate loss in Federal tax revenue resulting from a D.C. flat tax could be considerable. While we agree that establishing a flat tax for the District undoubtedly would lead to more locally raised tax revenue for the District government, whether this is a tax efficient way to make additional resources available to the District is a matter that should be more fully explored.

Whether—or how much—net new economic activity and jobs would be created in the District by a flat tax is unknowable but we certainly agree that enhancing the District's ability to raise revenue while enabling the City to lower its own local taxes is a goal we all share.

We thank you for your commitment to strengthening the District's economy and for your interest in making the City an even better place to live, work, and visit.

Senator BROWNBACK. Thank you, Mr. Golden.

I understand, Mr. Hill, you are just here for questions; is that correct? Or do you have a statement?

Mr. HILL. No, I do not have a separate statement.

Senator BROWNBACK. Okay, good.

Thank you for the comments and thoughts. I want to start off at the end and maybe work backwards here. Dr. Gandhi, one of the first meetings that you and I had when I took over this position was you were discussing with me the structural imbalance of the District and you were saying, look, we are $1 billion short annually. There seemed to be two main proposals that you were bringing forward at that time. Now, maybe there are other options, but as I was seeing it one was discussion of a commuter tax, so that people that come in, work in the District, help pay the costs within the District. The second one was a Federal subsidy of some form or another to help make up for the Government taking 40 percent of the property.

Are there other options, absent this option of a flat tax. But are there other options available for that disparity?

Dr. GANDHI. I think basically from the Federal Government perspective those are the key proposals that should be considered. But I do not have any illusions about the commuter taxes, nor do I have any illusion where the Government, the Federal Government, would just give away $800 million or so or $1 billion or so. So the question then is how can we find a way, one, to provide incentives for people to move to the city.

The heart of the matter is, as you pointed out, sir, that we have lost population. There were 100,000 more people living in the city. They are not living there today. My issue here is that if you live in the city you pay city's taxes. I do not care where you work, Virginia, Maryland, whatever. So how do we make city more attractive place to live, so that once you live in the city you pay city's taxes?

Now, as we have pointed out in our testimony, there is some demographic shift in this, in our households. But our population is not increasing. So we have to find a way in which to bring more people in the city.

Obviously, if there is a commuter tax here, that would be great. If we have a subsidy from the Federal Government, it would be even better. But I just do not have any illusions about that, sir.

Senator BROWNBACK. Neither do I have any illusions about that, because when I chaired the D.C. authorizing committee at the very outset people were bandying around a commuter tax. I heard clearly from one Virginia Senator quite quickly about that and I anticipated I would hear from the other and the Maryland Senators and some others possibly, too, on that pretty quickly. Then just the notion of a direct Federal subsidy in the quantities that would be needed is pretty hard to imagine in this budgetary environment.

So part of the reason for putting this forward was to offer another alternative of how you can make up for some of that lost ground.

You talked about, and maybe you hit it, about what would be the impact on businesses moving to the District. You go through a pretty good analysis, it seems like to me, from your office's perspective, about what happens to individual filers and what is likely to happen there. But I do not get as much of a feel from you on what you think would happen to businesses moving into the District. Do you have that or have I just missed it or is that just too hard?

Dr. GANDHI. No, sir. I think it is very difficult to gauge as to how many businesses will move in unless we know a concrete proposal, a very defined proposal with some specific provisions. The fundamental point in the case of businesses is their ability to expense their investment in the year in which they would incur the cost. That will be the fundamental attraction for them. So to the extent that we can do that, that would be a great incentive on the part of the businesses to come in.

But at the same time, the issue would be what about the businesses that already have a lot of inventory on their hands, a lot of equipment already on their hands? Generally, they claim the cost of goods sold, their depreciation, as tax deductions. So it depends upon what kind of transition rules you would provide, what kind of specific flat tax proposal you will provide for the businesses. All that will be a part of basic consideration for businesses to move into the city.

Further, they also want some kind of certainty. If they were to view this merely as a pilot project or an experiment for, say, 5 years, then my sense here is that they would be hesitant to move into the city, primarily because what happens after 5 years? So all these considerations are critical.

But the bottom line here is that businesses are looking at all times to reduce their costs. Tax is one of the most fundamental costs of doing business. So let us keep that in mind. Once you have a proposal that is far more defined, with specific rules, the transition requirements, then I think it would be better for us to be able to work with you and come up with numbers as to what our expectations are about businesses moving into the city or moving out of the city.

Senator BROWNBACK. Now, one of the people that testified at the last hearing said what an optional flat tax in the District would create a super-charged enterprise zone, in his terminology. What do you think of that as a descriptor for what this would do?

Dr. GANDHI. Sir, it does provide basically a safe harbor for people to say, look, if I do not like flat tax I will take the current tax if I am better off doing it that way. Again, it depends upon taxpayers, either individual or business, as to how they are located in their tax situation. If I am a taxpayer, a business taxpayer, with a lot of inventory on my hands, a lot of investment already on my hands, then my preference will be to stay with the current system because it allows me to take depreciation and cost of goods sold as my expenditures.

But if I were a new business coming into the city, then I can write off all my taxes as far as the investment and the purchases are concerned. So again, it depends upon what kind of specific provisions do we have for flat tax, what kind of transitional rules are we going to provide, and, given that you would give them a choice—hey, pick what you would like—it removes their initial concerns or fears about coming to the city.

Senator BROWNBACK. But overall you like the option of a flat tax for creating growth, economic growth and vitality in the District.

Dr. GANDHI. I think there is a great promise. But let us keep in mind, sir, if you look at my table 1 that we have in the testimony, what you see in the table is a very uneven distribution, almost a

bimodal distribution, of our taxpayers. So if you look at the taxpayers, say roughly 4 percent of them are paying 44 percent of the taxes, 17 percent of them paying 71 percent of our taxes. So if you have a flat tax here, what will happen is that there will be a substantial redistribution of taxes moving toward lower income taxpayers.

As you can see from the chart, roughly half of our taxpayers just do not pay taxes. So the question for us then is how are you going to make up for the lost revenue?

The second issue that we want to keep in mind here is that it would have social implications. So I think it is better for our policymakers, the elected leaders, the Mayor and the Council, to grapple with these issues before coming to a conclusion that the flat tax is the right thing to do.

Senator BROWNBACK. You noted that and that is a proper thing to note, is the social impact of this. You do not address that here and that is a proper thing to note. But I am just trying to get your outlook from the fiscal position on this. Now, if it is that you do not think this is a good idea fiscally for the District, then please state so as well.

Dr. GANDHI. As I pointed out, to the extent that it would bring in high income individuals or taxpayers, businesses, to the city, it is better off for the city in terms of it is going to raise our tax intake. As I just said, if you just add 500 people, 500 taxpayers at $200,000 or above in that income you are generating $30 million, just 5 percent. Ten percent would roughly double that.

So it would bring in people here that will pay more taxes. Two, it would also provide a lot of disposable income. Because these people are not paying taxes, they would have more to spend. So that could provide a lot of economic activity to the city.

The question that we want to keep in mind, however, is that one cannot simply look at flat tax from fiscal perspective, as you know better than I, and that is where the concerns are.

Senator BROWNBACK. The District has been losing population for 50 years. The surrounding suburbs have been growing rapidly. Why? We note the tax differential, but it cannot be exclusively that.

Dr. GANDHI. That is correct, sir. There are several considerations. Tax is one of them. As you have pointed out and we have pointed out in other testimony, we have a very high tax rate, even though the Council and the Mayor have engaged in a tax parity initiative whereby we are reducing our taxes. But for a long time our tax rates have been very high, higher than regional jurisdictions and, as I pointed out, higher than practically all States except two in the country. So that is one very important consideration.

But at the same time, 10 years ago we had a major public safety issue here. Schools are a major problem even today, even though we have a very energetic superintendent and the city has committed to put a lot of money in our school infrastructure. But still, if you are a family with young children, schools are a very, very important consideration.

The last of all is an affordable housing crisis. The city has a major problem in being able to provide housing at an affordable

level. So when you put all these things together, we have lost a substantial number of people as you pointed out, sir.

Senator BROWNBACK. What is the city doing to encourage middle class families to move into the city?

Dr. GANDHI. Well, as I pointed out, the city is engaged in lowering our tax rates. Now from something like 9.5 at one point in time, now our tax rate will be around 8.7 beginning this year. Further, we have substantially improved our public safety environment. As I pointed out, the schools are a major priority for the Mayor and the Council. I think all in all the city is also engaged in providing a lot of funding for affordable housing.

But all this will take time, I would say close to 5 to 10 years, before we could turn around the corner on that.

Senator BROWNBACK. I want to look at the number of married filers in the District.

Dr. GANDHI. Yes, sir.

Senator BROWNBACK. You testified that it was at only 20 percent compared to 45 percent nationally.

Dr. GANDHI. Yes, sir.

Senator BROWNBACK. Now, has the number of married filers in the District declined over the decades and what is the reason for this?

Dr. GANDHI. Well, again I think that has been the case. If you are married with children, schools are extremely important. And if we cannot provide adequate academic environment here, people with children would leave, and we have seen people leaving. The out migration that we have seen are basically with the families with children. The in migration that we have seen are the households which are basically single people or two-income, no children families.

The question at the end of the day is for any married couple, with or without children, are we going to be safe here? When we have children, will we have good schools to send our kids to, and can we afford to live in the city? Those are the key considerations, and the Mayor and the Council have been engaged very deliberately in a very considered effort to improve on those fronts. But as I pointed out, it will take some time.

Senator BROWNBACK. Mr. Golden and Mr. Hill, I talked at the outset with Dr. Gandhi about the other sourcing for infrastructure money. You noted the infrastructure needs that you have here, budgetary needs that you have, $2 billion needed for schools, $200 million for a crime lab. I thought you said $4 billion for roads and road needs. I do not know if you put a number on that.

Mr. GOLDEN. No, we did not.

Senator BROWNBACK. Okay. I know the number is large. But do you have another option for creating tax revenue for the District outside of the two, three we have talked about today, a Federal subsidy, a commuter tax, or a flat tax that creates more growth? Do you have another option?

Mr. GOLDEN. I really do not think there are——

Senator BROWNBACK. I do not think that mike is on.

Mr. GOLDEN. There we go. Is that better?

Senator BROWNBACK. Yes.

Mr. GOLDEN. I am not sure that there are a lot of great options there. Clearly, as far as our capital needs are concerned, as far as issuing further debt or something of that sort, we are getting very close to the overall limit. I think Dr. Gandhi has placed a cap on our city of about 11 percent of our total budget being used to pay debt service on our bond debt and so forth. When you look at we were already over $4 billion in indebtedness and the number was a total of around $4 billion, including education and a lot of other factors, we are at a limit there.

I do not think we can necessarily tax our way out of that dilemma. So it is a major issue for us. I think clearly what you are pointing the direction in is the direction of getting more people inside the city, both businesses and individuals, to share the burden. And I think that that is clearly a good strategy.

I also do think that the Federal Government continues to have an obligation. You know, the crime lab is there to serve our responsibilities as being a first responder, as an example. We were saddled when we became in charge of our own welfare here in the District, the residents had voting power, we were saddled with an overall burden from the Federal Government from years past of, as an example, the schools of $2 billion of facilities there.

So it just seems to me to push that off on another group of taxpayers when in fact the Federal Government left the District in a very—when you left it to the District it was 570,000 residents, but very few taxpayers. I do think there continues to be a Federal responsibility for addressing some of those issues.

Dr. GANDHI. If I may comment on that, Mr. Chairman. I think the fundamental point that we want to remember here is that, even though we enjoy being the Nation's Capital and we are very proud of being host to the Nation's Capital, but basically the city is paying roughly $500 million annually for what I would call a state-like function, like how many States—how many cities run universities or Medicaid or mental health or a tax department?

We have to carry all these expenditures on our shoulders and we cannot afford to do that. As Mr. Golden pointed out, you cannot tax any more. Indeed, we are going the other way. We are trying to reform our taxation and lower the tax rates. And also we cannot borrow any more. I have already pointed out to our Mayor and the Council that if we want to borrow any more it would have negative impact on our bond ratings and we do not want to go there.

Senator BROWNBACK. You noted at the end of your testimony that this is kind of a halfway step between what we do now and Puerto Rico.

Dr. GANDHI. Yes, sir.

Senator BROWNBACK. Where we have no Federal tax, tax on local earnings.

Dr. GANDHI. Yes, sir.

Senator BROWNBACK. Why do you make that analogy and example? You view this as a way of creating that type of half step, or just that that is a convenient shorthand way of looking at what this would do?

Dr. GANDHI. I would like to do it full way. We would like to basically keep all the local taxation in the city. We pay roughly $2.5 billion every year from the District to the Federal Treasury in in-

come taxes. That is a lot of money to be paid for a jurisdiction that is not a State. My sense here is that the Puerto Rican solution is an excellent one.

But the question is, do I have illusions about that? I do not think so. The important point, however, is, how do we get some way to expand our tax base? Our Mayor had, oddly enough, said that his goal was to bring in 100,000 more people to the city. To repeat myself, if you live in the city you pay city's taxes. So how do we increase our population, taxpaying population? The more important thing here is that we have to improve our schools, our public safety environment, we have to make our housing affordable, and our taxes have to be far more competitive with our region's, because we are competing against world-class jurisdictions—Fairfax, Montgomery. One Metro stop and you are in Fairfax or in Montgomery County.

Senator BROWNBACK. But if you created zero Federal income tax in the District, say that if we are going to be here but not represented, taxation without representation, then how about pulling the taxation off. Would you not take your social issues that you have been very deeply concerned about and mentioned here, would you not exacerbate those even greater if you had zero Federal tax here?

Dr. GANDHI. Well, I think the important thing is that we have to make sure that even if there is a flat tax here the District's taxes also have to be moderate, that we cannot be—we cannot simply compensate, that whatever you were paying to the Federal Government now you pay to the District government. I do not think that would work. The question here is that we ought to provide an economic environment here whereby we can have more people come into the city and do business and leave peacefully.

Senator BROWNBACK. I agree with that. It is just it seems like that if you had a zero Federal tax place here in the District of Columbia, your charts that you were talking about skewing people that would be attracted here go off the charts at that point in time. Then you have got a lot of people with substantial income saying, all right, I have got a real place I want to live now.

Are your concerns not magnified?

Dr. GANDHI. That is where the political and the social policy issues come into play. That is the decision that the elected leaders and you, sir, would have to make as to what kind of Nation's Capital do we want, who do we want to live here. That is a very, very important question. I really do not have answers for those questions.

Senator BROWNBACK. I am just trying to kind of pin you down where you are on this and I am having difficulty really trying to ascertain that, Dr. Gandhi.

Dr. GANDHI. These questions are beyond my——

Senator BROWNBACK. But I think I understand what you are saying.

Dr. GANDHI [continuing]. Beyond my pay scale, sir.

Senator BROWNBACK. That economically this is a big plus, but you have got other considerations as well.

Dr. GANDHI. That is correct, sir.

Senator BROWNBACK. But economically that is why I offer my State up. If you would let us do it, I would be very happy about that. I recognize there are other considerations to it and there always are in tax policy because those have social impact to them as well.

Well, thank you. I am appreciative of your thorough analysis, particularly on the individual rates and impact and individual income tax options. I think we ought to be able to take those same sorts of options and put them in a business framework and be able to determine what would happen to business activity. But maybe that is too much to try to model. It would be interesting to see that, but that is something we can try to generate from Federal sources of that type of information, because my guess is there would be a substantial impact on business creation and formation in the District of Columbia if there was stability to that type of system, and we will have to see what that is.

Dr. GANDHI. And we will work with you, Mr. Chairman, to refine the proposal and also come up with some scenarios as to how businesses can be expanded with a different kind of flat tax.

Senator BROWNBACK. Mr. Hill.

Mr. HILL. In answer to your previous question about other ways that it might be possible to increase and expand the tax base for the District, there are a number of parcels of land in the District that are currently owned by the Federal Government and also ones that are being looked at in terms of redevelopment. The ability to take some of that property and put it into the tax base for the city could have significant benefits for the city.

The Mayor in his plan to increase the number of taxpayers by 100,000 also included as part of that not just bringing new people into the city, but trying to address the literacy issue, which keeps a number of our citizens out of the workforce and therefore makes them not qualified to take some of the jobs that are even created here, so that people from outside the city have to come in because they are more qualified to take those jobs.

So I think that a combination of those factors as well as the State functions issue that Dr. Gandhi made could have a significant impact on additional revenue for the city.

Senator BROWNBACK. Okay. Has the Federal City Council identified those parcels that you would like to see conveyed from the Federal Government to the District?

Mr. HILL. Well, there certainly is one parcel now that is under discussion, Walter Reed Hospital, and what should happen with Walter Reed. It is clear that the District is very interested in the possibility of developing that in a way that it could bring in new residents and also bring in additional businesses to that area. Certainly the State Department is interested in it for the possibility of having additional Embassies, which would further exacerbate the problem of having this property in the tax base, as well as the General Services Administration (GSA) is interested in it in order to provide additional space for government facilities.

So of those three competing uses, it is quite clear that some of the uses that the District would want for that property would help. And I know that the city has looked at other parcels of land as well that could potentially be transferred to the city.

CONCLUSION OF HEARINGS

Senator BROWNBACK. Good. Thank you all very much for your time and effort and your analysis on this. If you have additional statements you want to put into the record, please let us know.

Julia, I want to thank you particularly as the economist. I know you did a lot of the work on this analysis and I appreciate all that effort and focus in your doing that.

The hearing is recessed.

[Whereupon, at 2:43 p.m., Thursday, March 30, the hearings were concluded, and the subcommittee was recessed, to reconvene subject to the call of the Chair.]

○